

## The dynamics of reforms in resources-rich countries:

### Towards incentive-compatible approaches

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*When properly managed, natural resources can effectively contribute to sustainable and equitable development. Yet, too often, resource-rich countries have failed to capitalize from the benefits and transformative potential of their natural endowment. Poor or inappropriate governance and institutional structures have commonly been blamed for this resource curse. While political economy considerations have usefully been advanced to explain some of these weaknesses, proposed remedies have often been prescriptive in nature, focusing on best practices. However, it might be more effective to take greater account of the dynamics of reforms in resource-rich countries. This would notably entail also adopting a political economy approach to identifying incentive-compatible reforms, as well as promoting initiatives that can enhance domestic incentives towards a pro-development path in resource-rich countries.*

#### Why the resources curse?

The abundance of natural resources has both the potential to stimulate an economy or to hamper its development (e.g. Ramdoo, 2012). How riches can turn bad has been commonly referred to as the 'resources curse' or 'paradox of plenty'. The poor performance of some resource-rich countries can be explained by a number of economic factors, including possible negative effects through the terms of trade, the cyclical long term price fluctuation of commodities, short term high price volatility of commodities, the crowding out of manufacturing and the *Dutch disease*, according to which the natural resources sector grow at the expense of manufacturing, and associated notably to real exchange rate appreciation. It can also be explained by power relations and institutional settings. Natural resources create rents, which affect incentives and behaviour of political and economic actors. Political elites play a central role in the collection and allocation of these rents and the distribution of revenues generated directly and indirectly by the exploitation of natural resources. Accordingly, they may pursue self-interest objectives rather than development goals in the management of natural resources, and thus capture these rents. Economic actors are also more likely to engage in wasteful rent-seeking activities, thus diverting resources away from the productive sector. Rents in turn affect the economic structure, political framework, institutional setting and power relations within a country, particularly where patronage prevails. Foreign partners, governments or companies, in their pursuit of their own interests, have also at times contributed to reinforce these negative tendencies and the associated resource. The competition for the control and allocation of natural resources and the revenues they generate may lead to political instability, conflicts and authoritarian regimes (e.g. Auty, 2007; Barma *et al.*, 2012; Kolstad and Wiig, 2008; and Rosser, 2006).

In other words, governance matters! The (*mis*)management of natural resources plays a central role in determining whether rich resources endowment turns out to be a curse or a blessing. Understanding the domestic context, including the economic, political and institutional settings and power relations, is therefore of paramount importance.

## Adopting a political economy approach

As a result, greater attention has been paid in recent years to the political economy of resources management. Numerous studies have attempted to explain the dynamics of the resources curse and the institutional and policy gaps that makes it more likely. In doing so, greater insight has been gained on the self-reinforcing interaction between poor governance and mismanagement of natural resources, which tend to be mutually reinforcing (e.g. Arezki *et al.*, 2012; Collier, 2010; Frankel, 2012; Lederman and Maloney, 2007). A number of policy recommendations and measures have also been formulated, with a view to improve the management of natural resources, so as to overcome the pitfalls of the resource curse. These concern a broad range of issues, including the legal and regulatory environment required, the macroeconomic policy framework, the appropriate fiscal regime and budgetary process, exchange rate policy, the institutional setting and mechanism, the role of sovereign wealth funds and stabilisation funds, sustainability and environment criteria, production diversification, social development, conflict prevention, etc. (e.g. Arezki *et al.*, 2002; Conceição *et al.*, 2011; Frankel, 2012; IMF 2012a, 2012b). The thrust of the recommendations generally centre on the need to build or strengthen the capacity of the state to better manage its natural resources, improve its governance, increase transparency and accountability mechanisms.

## From best practice to good fit

While recognizing the challenges posed by weak governance and institutions, the approach commonly adopted to promote reforms focuses on 'best practice', or at least 'good practice', as the norm which a reforming developing country should try to emulate to remedy its weaknesses and unleash the potential benefits from its natural resources. An approach more in line with the political economy insights would go a step further, and explicitly take into account the country's specific context. This would suggest that the notion of 'good fit' should be more appropriate for a reform agenda, based on the perspective of 'good enough governance' (Barma *et al.* 2012). This is the recognition that in a dysfunctional environment, solutions must be tailored to address the constraints faced. Attempts at transposing optimal designs and measures to manage natural resources may not be very effective approaches in poorer and weaker economies. What works well in Norway may not fit well in the Democratic Republic of Congo. The 'good fit' approach echoes the theory of second best, familiar to economists, according to which in the presence of multiple distortions in an economy, the ideal, first best solution to address one distortion may have adverse effects on the economy.

## Promoting incentive-compatible reforms

In addition, incentives and constraints faced by political and economic actors should systematically be made more explicit and taken into account, not only in identifying the cause of the mismanagement of natural resources, but also in identifying the dynamics of a reform agenda. Many reform processes, while based on sound advice grounded in good practice, do not get the necessary domestic buy-in by policy makers to succeed. The causes are often well known, but not factored in the remedies advocated.<sup>1</sup> Measures to address the resource curse challenges should therefore better integrate the domestic incentives to undertake the necessary reforms. Instead, problems of capacity and institutional designs are too often addressed in a technocratic manner, as if immune from the power and economic (self-)interests and incentives of the ruling and dominant actors (see Box 1). More effort should be dedicated to design

<sup>1</sup> This has led the World Bank, for instance, to assess in the case of the mining sector in Ghana that "prior reform initiatives were not designed with the deep-rooted challenges in the political environment in mind", recognizing that in spite of ongoing support programmes, "Considering previous and current reform initiatives [...] the government has made only marginal improvements in dealing with issues of national sovereignty, social contract, mining's enclave character, the relationship between the mining companies and the communities, and revenue maximization" (Ayee *et al.*, 2011).

reform measures to address the resource curses that are incentive-compatible with the key stakeholders in charge of conducting and implementing such reforms. When first-best policy measures cannot get the necessary endorsement and support of key political and economic actors, a menu of second-best, incentive-compatible interventions, being politically feasible, may ultimately prove more effective.

**Box 1:**

“Improving the institutional environment is particularly difficult where key players benefit from dysfunctional institutions. It is unlikely that corrupt government officials would support or implement reform significantly reducing their own powers of appropriation. The existing focus of donor support on capacity building, horizontal accountability, technical assistance and macro-economic management is hence unlikely to create the required institutional change in resource-rich countries.” (Kolstad and Wiig, 2008, p.12)

Surprisingly, little consideration has been given to provide a more systematic assessment of incentive-compatible, politically feasible measures to address the resource curse. Many of the recommendations on how to better manage natural resources (e.g. Arezki *et al.* 2012; IMF, 2012a, 2012b) offer little insights into the political feasibility of the reforms advocated, even when the analysis of the causes of the resource curse builds on a political economy approach (e.g. Frankel, 2012). At best, this orthodox approach to policy recommendations is adjusted, too often only at the margin, in an *ad hoc* manner, to get the formal approval at the domestic level.

Such shortcomings are increasingly recognized however, though by far, not yet mainstreamed. The World Bank has supported some pioneering work in an effort to frame interventions in natural resources management according to the domestic political environment (Barma *et al.*, 2012). Issues of political regimes and their inclusiveness (based on categories such as patrimonial rule of individualized power and crony hierarchy, hegemonic government with one-party regime, clientelist pluralism and patronage, and programmatic pluralism with electoral competition and accountability) are key determinant to identify an incentive compatible reform agenda and the credibility of the commitments made. Taking into consideration the domestic setting can lead to sharply contrasting recommendations (Siegle, 2009). Consider the case of cash transfers for instance, which aim to distribute (some) natural resources revenue directly to all citizens, in an effort to improve domestic accountability and increase all people income. The desirability of such cash transfers and their impact on development and governance does depend on the political incentives, institutional setting and administrative capacity of a country (Gillies, 2010). Only more inclusive forms of government, less riddled by corruption, and eager to generate greater support from the majority, will favour such policy, whose impact on development will also depend on the political commitment and long-term sustainability of cash transfers mechanisms and governance.

## Altering incentives towards a reform agenda

Another complementary venue to promote a more effective management of natural resources is to alter the incentives of the ruling elite, whose vested interests and power dynamics may otherwise bolster the resource curse. Such strategies may include interventions that seek to extend the time horizon of policy makers (hence reducing their perception of possible short term losses due to policy reforms) or mobilising stakeholders (so as to increase the ranges of interests involved, notably those of potential drivers of change). Interventions that seek to ‘enclave capacity and institutions’ related to natural resources have also been advocated by the World Bank as an additional mechanism to promote better governance (Barma *et al.*, 2012). This is also the principle at play with proposals to develop ‘early reform zones’ (Auty, 2007), such as in the case of special economic zones for instance.

In this context, the emphasis on economic and structural transformation, as a necessary complementary approach to benefit from natural resources, may prove most important to break the potential vicious cycle of the resource curse. This is important not only in the framework of development policies, harnessing the benefits of natural resources to stimulate the rest of the economy and society. It can also play a central role in shifting the power and economic relations prevailing in the management of natural resources by broadening the scope of interests and stakeholders affected by the management of resources. Greater emphasis on the transformative role of natural resources *de facto* contributes to mobilize a new set of stakeholders (including potential drivers of change) and to change the focus and time horizon of policy makers involved in resources management. More attention should be devoted to these potential new dynamics for reforms in resource-rich countries, and the conditions under which the incentives to improve the management of natural resources can be enhanced.

## International drive

Another well recognized factor for affecting domestic incentives for reforms are international initiatives. International initiatives can usefully influence domestic dynamics, positively affecting the incentives and constraining the decisions of policy makers in favour of a more effective management of natural resources and strengthening domestic drivers of change. There is no silver bullet mechanism to address governance weaknesses, and so the range of international initiatives, public and private, binding and voluntary, may all contribute, in various ways, to affect the domestic political economy context and reform dynamics of resource-rich countries.<sup>2</sup> Some of the most prominent international initiatives include for instance the Extractive Industry Transparency Initiative (EITI), the Kimberley process, the OECD Guidelines on Due Diligence for Responsible Supply Chains, and from a regulatory perspective, the US Dodd-Frank Act and the EU transparency and accounting directives.

The thrust of most of these initiatives is to promote transparency, as a voluntary good practice or an obligation, on the supply chains for natural resources, contracts or revenues from natural resources. The stakeholders concerned are resource-rich governments and/or private companies. The strategy relies upon the principle that greater transparency should lead to greater accountability and better management of natural resources; this can be done through naming and shaming governments mismanaging their resources, as well as through preventing them, or at least pressuring them not to divert or capture natural resources revenues. The decision by the International Monetary Fund (IMF) at the end of 2012 to withhold \$225 million loans to the Democratic Republic of Congo (DRC) because of its failure to publish adequate details on mining contracts in 2011 is an illustrative example of the incentives that the international community can use to promote a more transparent management of natural resources.<sup>3</sup>

Private companies are also being held accountable, through regulatory processes combating corruption (e.g. an US anti-corruption law such as the Foreign Corrupt Practices Act), their accounting disclosure obligations (e.g. US Dodd Frank Act or EU Transparency and Accounting Directives), their commitment to abide by codes of conduct and due diligence principles (e.g. OECD guidelines or the recent Conflict-Free Gold Standard of the World Gold Council). Managing reputational risks has become an increasingly important factor for more inclusive business drives as well as for incentivising governments to improve the management of their resources. In this respect, greater effort should also be devoted to provide additional incentives to enhance the transparency and accountability of resource-rich countries to the expenditures side of their activities, and not only the revenue side, as too often the case (e.g. Kolstad and Wiig, 2009).<sup>4</sup>

Donors have also the ambition to positively influence the management and governance of natural resources through the dedicated financial and technical support they provide to resource-rich developing countries. Aid conditionality, as in the case of budget support for instance, has also been one of the mechanisms pursued. While development support can definitely play a useful role, notably in terms of building domestic capacity and facilitating some initiatives, in most cases it has however reached little results in altering the incentives of the ruling elites and generating new dynamics for reform.

## African initiatives

Besides such initiatives from the international community, an increasing source of dynamics for shifting domestic incentives towards a pro-development path in resource-rich countries comes from collective action in Africa, at regional and the continental levels. The pan-African new impetus to boost development has led African leaders to pay greater attention to the management of their natural resources. This has led to the adoption of the Africa Mining Vision for instance, and its action plan, which puts great emphasis on home-grown, African driven initiatives to better harness the development potential of the extractive sector. The specific role granted to the African Peer Review Mechanism (APRM) to scrutinise and advance better governance in the extractive sector is also an encouraging development. Natural resources also stand high in the agenda of other regional initiatives, such as the International Conference of the Great Lakes Region

<sup>2</sup> This has been interestingly referred to as ‘fox type’ approach by Galvao Ferreira (2012), uncoordinated and flexible approach to addressing complex and context specific challenges in natural resources.

<sup>3</sup> See Bloomberg, “IMF Halts Congo Loans Over Failure to Publish Mine Contract”, 3 December 2012, [www.bloomberg.com/news/2012-12-03/imf-halts-congo-loans-over-failure-to-publish-mine-contract-2-.html](http://www.bloomberg.com/news/2012-12-03/imf-halts-congo-loans-over-failure-to-publish-mine-contract-2-.html)

<sup>4</sup> Such required broadening of focus is somewhat reflected in an initiative like *Publish What You Pay* (PWYP), which now also encompasses issues such as Publish What You Earn and How You Spend as well as Publish What You Pay and What You Extract (see [www.publishwhatyoupay.org/about/publish-what-you-earn-and-how-you-spend](http://www.publishwhatyoupay.org/about/publish-what-you-earn-and-how-you-spend)).

(ICGLR) and the agenda of many of the Regional Economic Communities (RECs) in Africa (such as the ECOWAS directive on mining, the SADC Protocol on Mining, etc.).

The approach currently emerging in Africa is one where greater emphasis is put on identifying synergies among various initiatives, and linking up natural resources to broader development considerations (e.g. ECDPM, 2013; Ramdoo, 2013; UNECA, 2013; UNECA and AUC, 2013). As a result, shifting away from the dangers of a resource curse entails not only a better management of natural resources, but also the harnessing of natural resources to the structural transformation of Africa, and with other African initiatives such as the Programme for Infrastructure Development in Africa (PIDA) and the Accelerated Industrial Development of Africa (AIDA). Provided such pan-African and parallel regional initiatives generate sufficient buy-in from domestic stakeholders, the continental and regional frameworks offer a distinct avenue to alter the domestic balance of interests in resource-rich countries. They have the potential to create new incentives, for both policy makers and economic actors, which may modify power relations, rent-seeking and patronage behaviours. The challenge remains to translate this potential into reality. This will require greater attention to the effective translation of generic policy designs into specific actions, within as well as across policy frameworks, and into each of the countries concerned. In doing so, greater consideration should be given to how such initiatives can positively affect incentives for reforms and the balance of interests and power in resource-rich countries, that is the political feasibility of creating a virtuous cycle of development oriented reforms.

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