The Political Economy of Reform in Resource Rich Countries

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High-level seminar on
Natural resources, finance, and development: Confronting Old and new Challenges
organized by the Central Bank of Algeria
and the IMF Institute
in Algiers on 4-5 November 2010,

Background

- 1950s and onwards:

  Countries that specialize in production of natural resources will do poorly because such production will not be very profitable

- Recently:

  Countries that specialize in production of natural resources will do poorly because such production will be very profitable

Background

- The average effect of oil is not the most interesting
- Why do some resource rich countries do so well while others do so badly?

Answer: Politics

- ….but then why does politics differ?

- Potential answer:
  Because the political incentives differ

Two questions

- How do countries reform when they receive resource rents?

- How should countries reform when they receive resource rents?

How do countries reform when they receive resource rents?

- New economic opportunities $\Longrightarrow$ reform

  -1862 US Homestad Act

  -1990 Norwegian Petroleum fund

  -South-East Asia timber institutions

  -Checks and balances in e.g. Venezuela

- The type of reform initiated will be very different across countries

How should countries reform when they receive resource rents?

- More difficult question…

- First – let us contrast the economic response between:

  1. Countries with politicians and private entrepreneurs unchecked

  2. Countries with politicians and private entrepreneurs checked

Figure 1

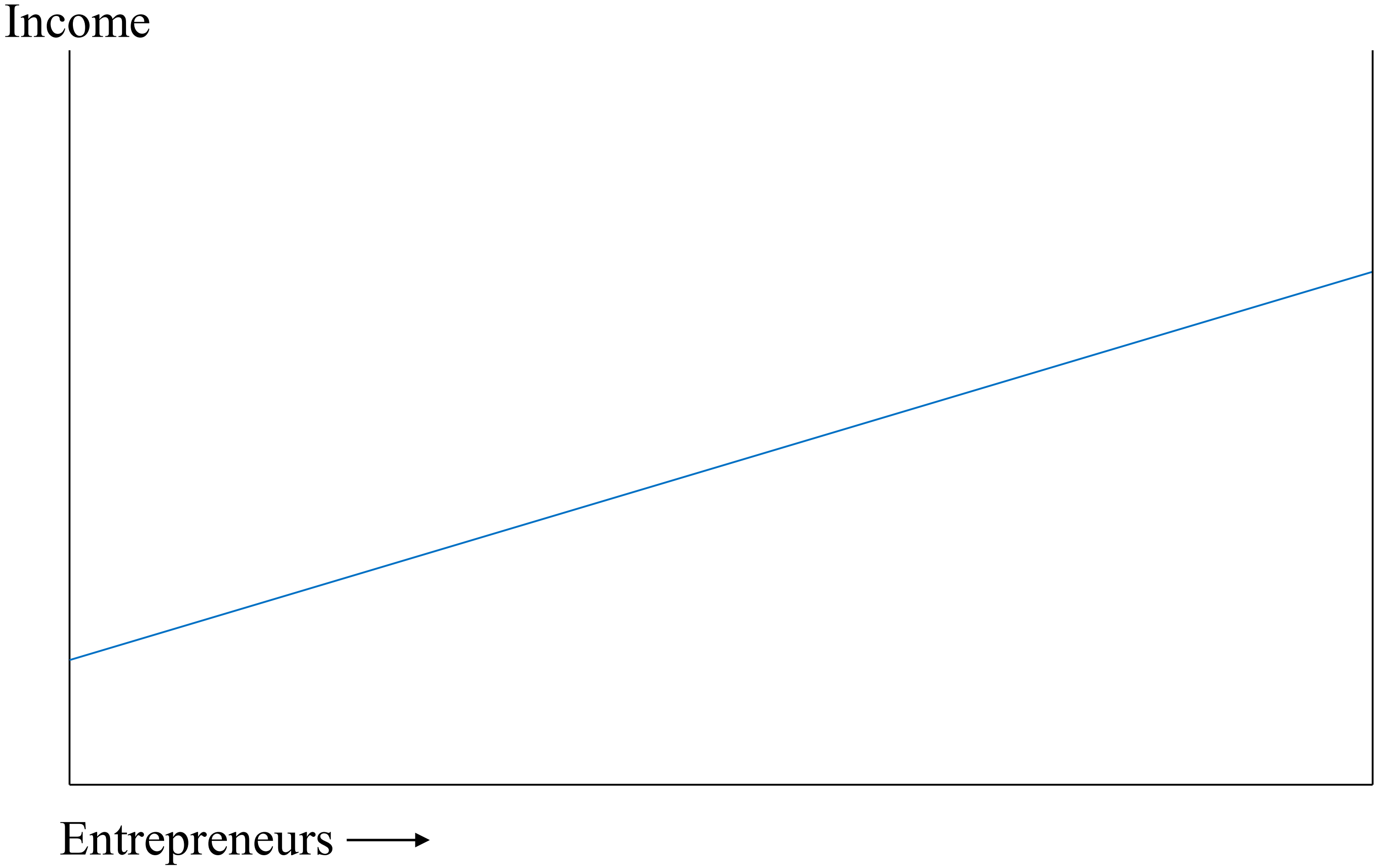


Figure 2

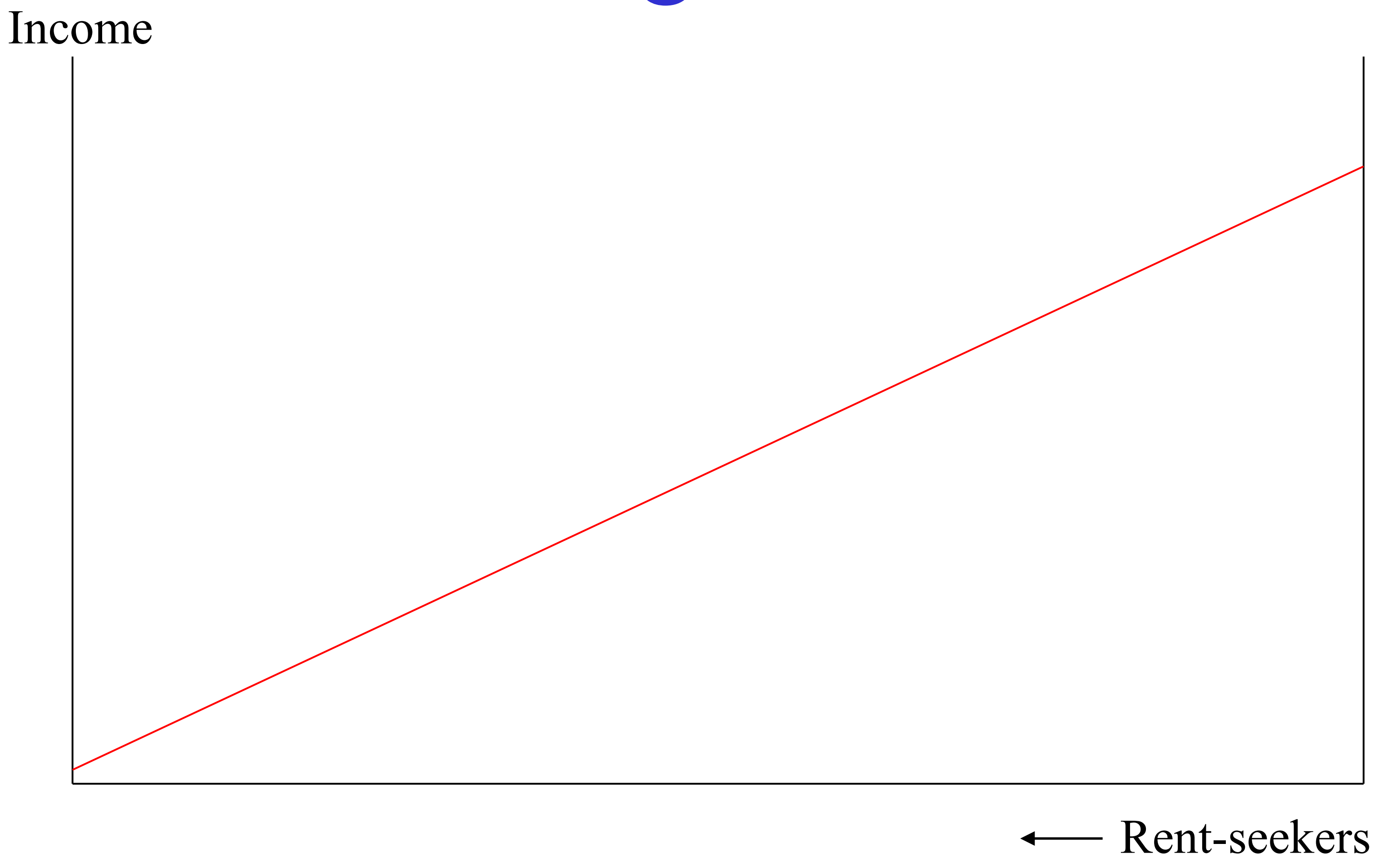


Figure 3

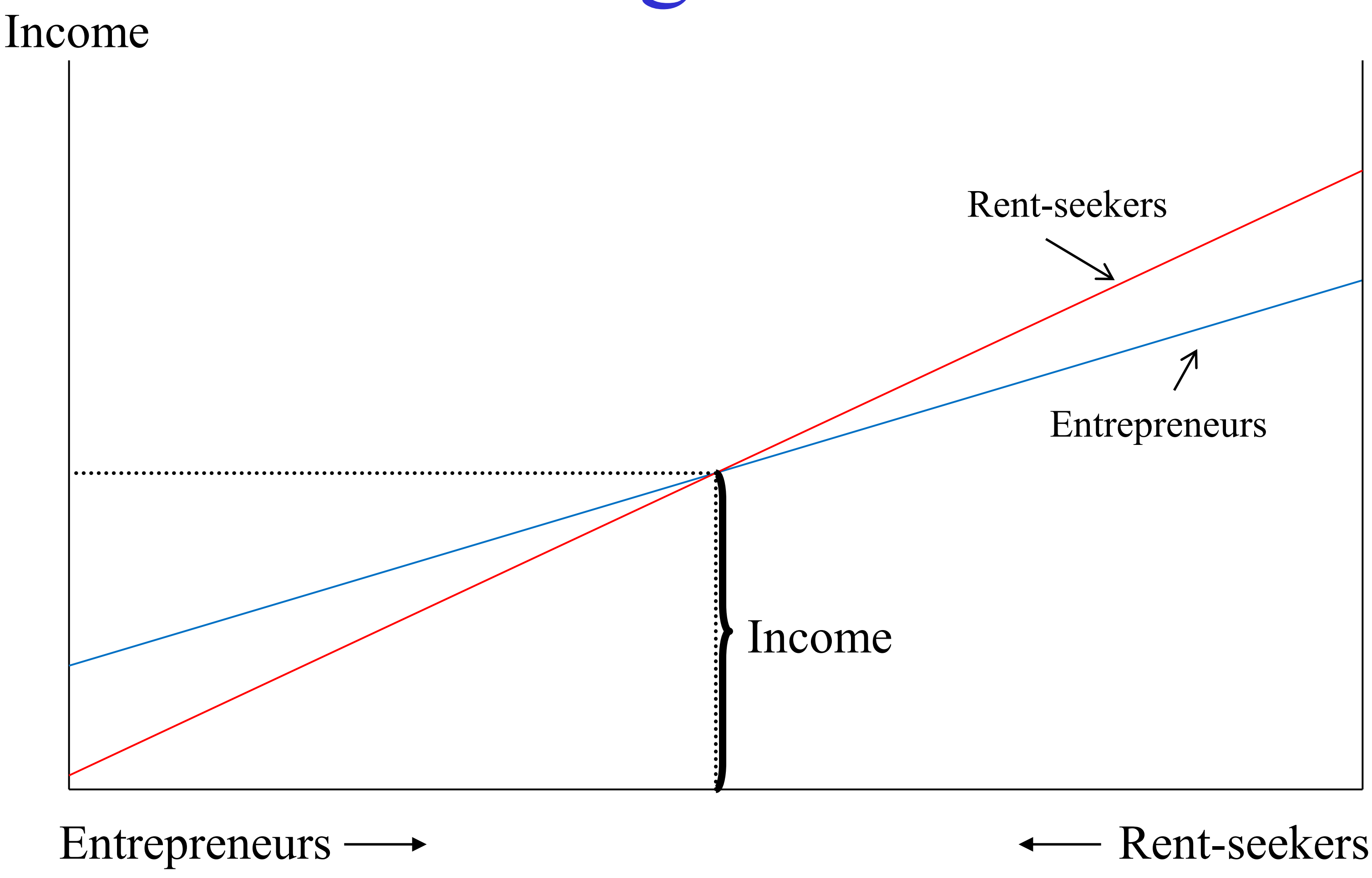
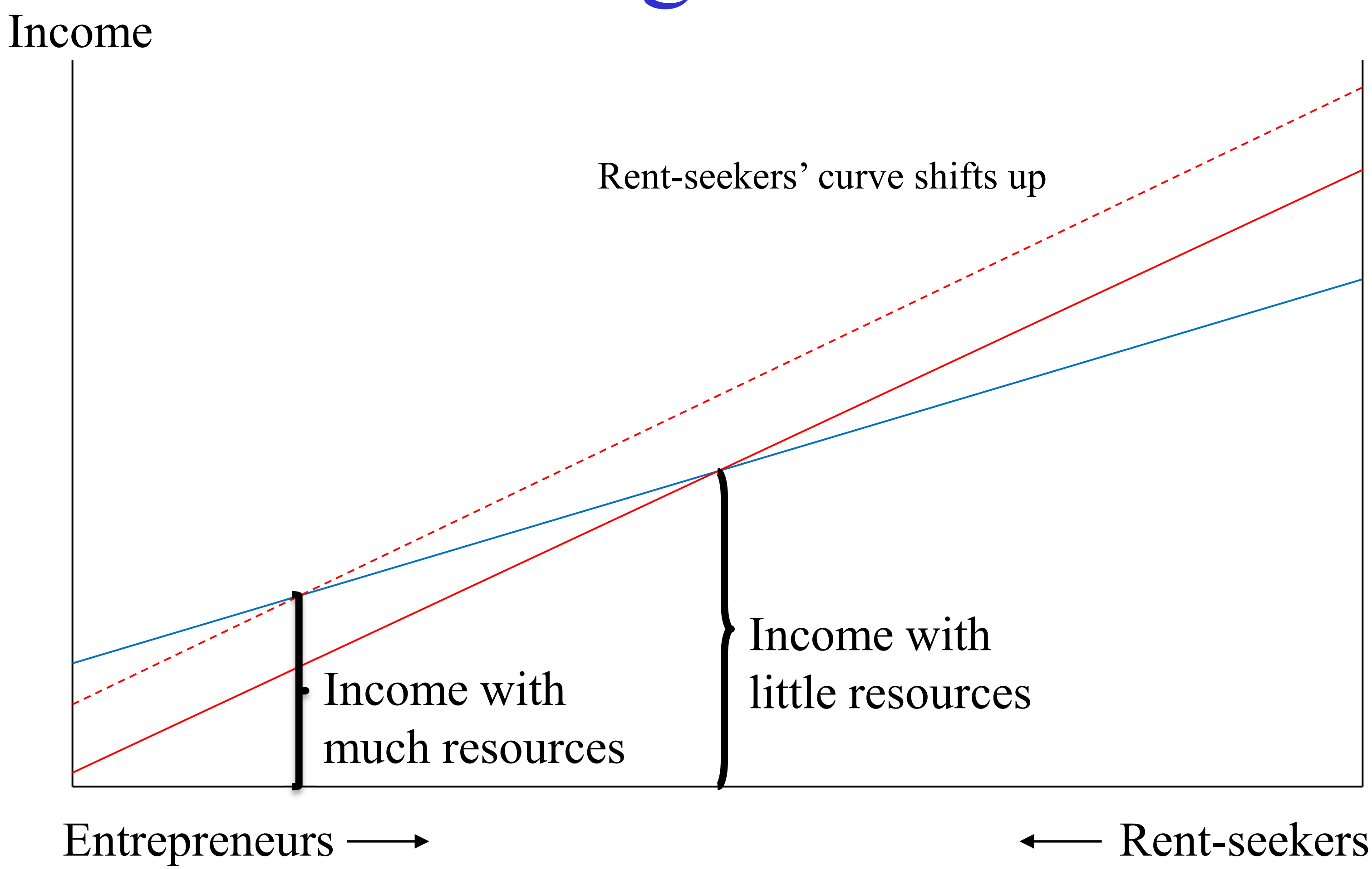

Income
Rent-seekers
Entrepreneurs
Income
Entrepreneurs
Rent-seekers

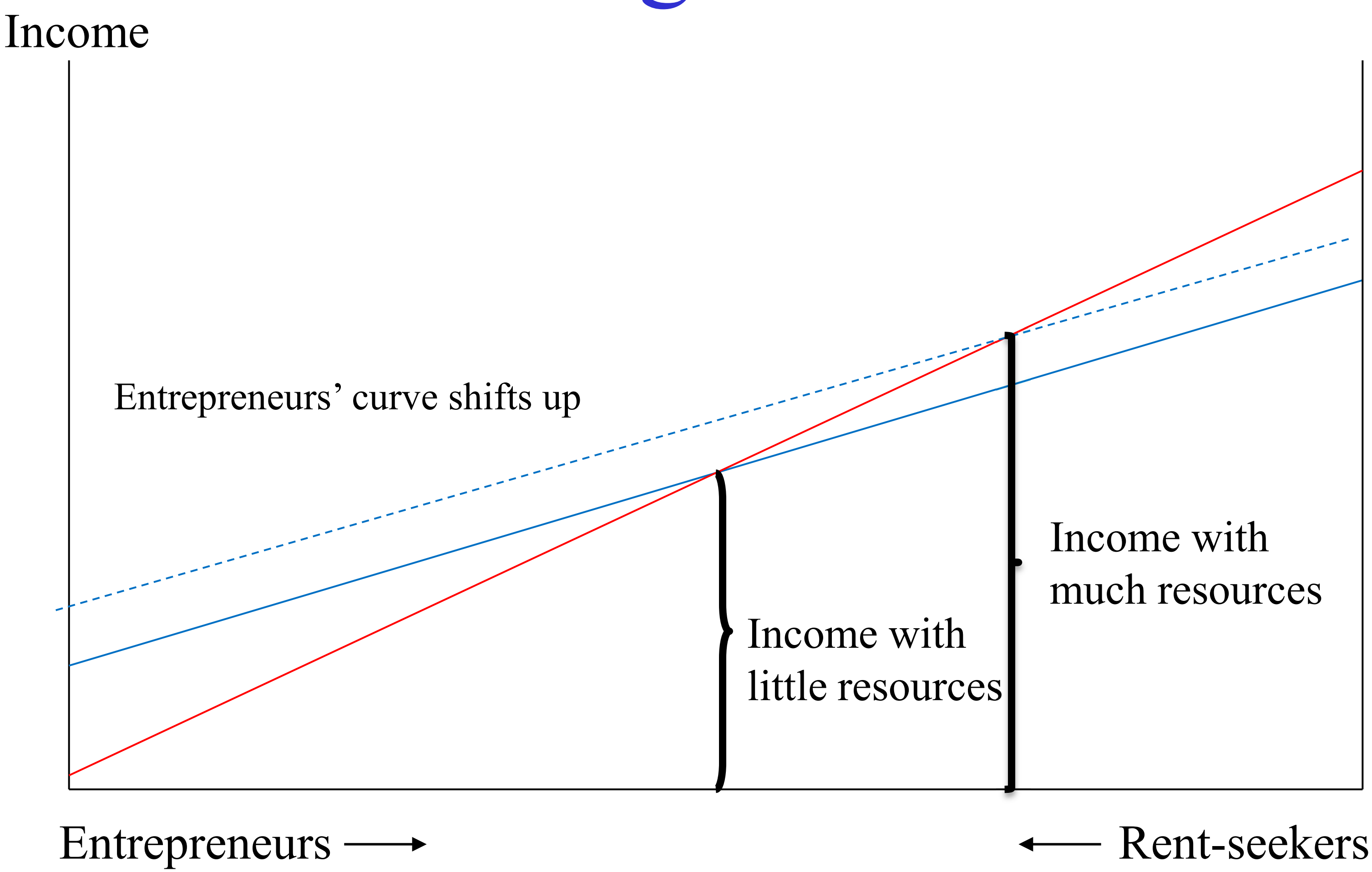
Figure 4


Income
Rent-seekers' curve shifts up
Income with
much resources
Income with
little resources
Entrepreneurs →
← Rent-seekers

Unchecked entrepreneurs

- Better income opportunities for all reduce total income!
- We have a multiplier process – but is has a negative sign

Figure 5


Income
Entrepreneurs' curve shifts up
Income with
much resources
Income with
little resources
Entrepreneurs
Rent-seekers

Checked entrepreneurs

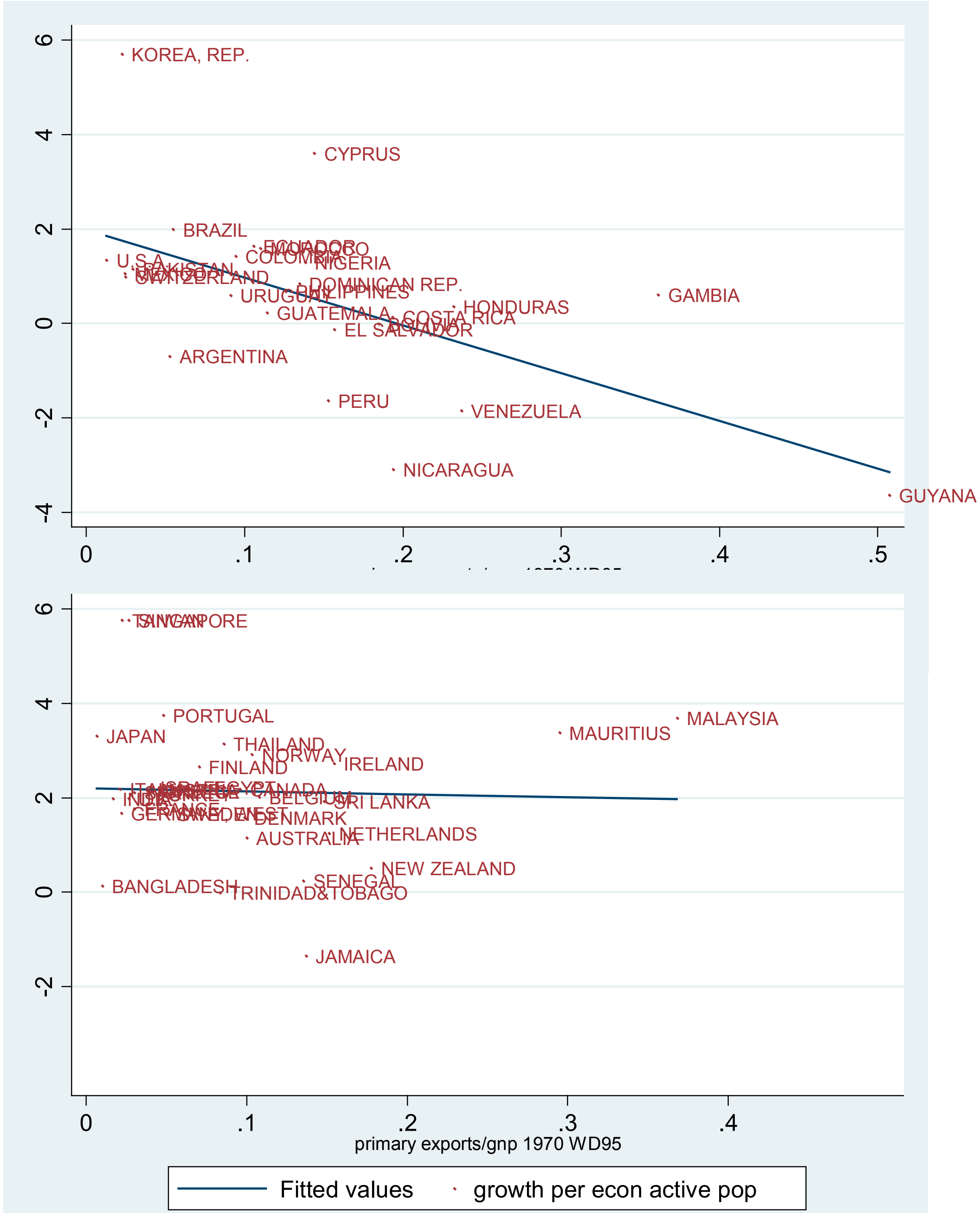
- Better income opportunities increases income by more than the value of the opportunities

- We have a multiplier process – and this time the sign of the multiplier is positive

Which reforms?

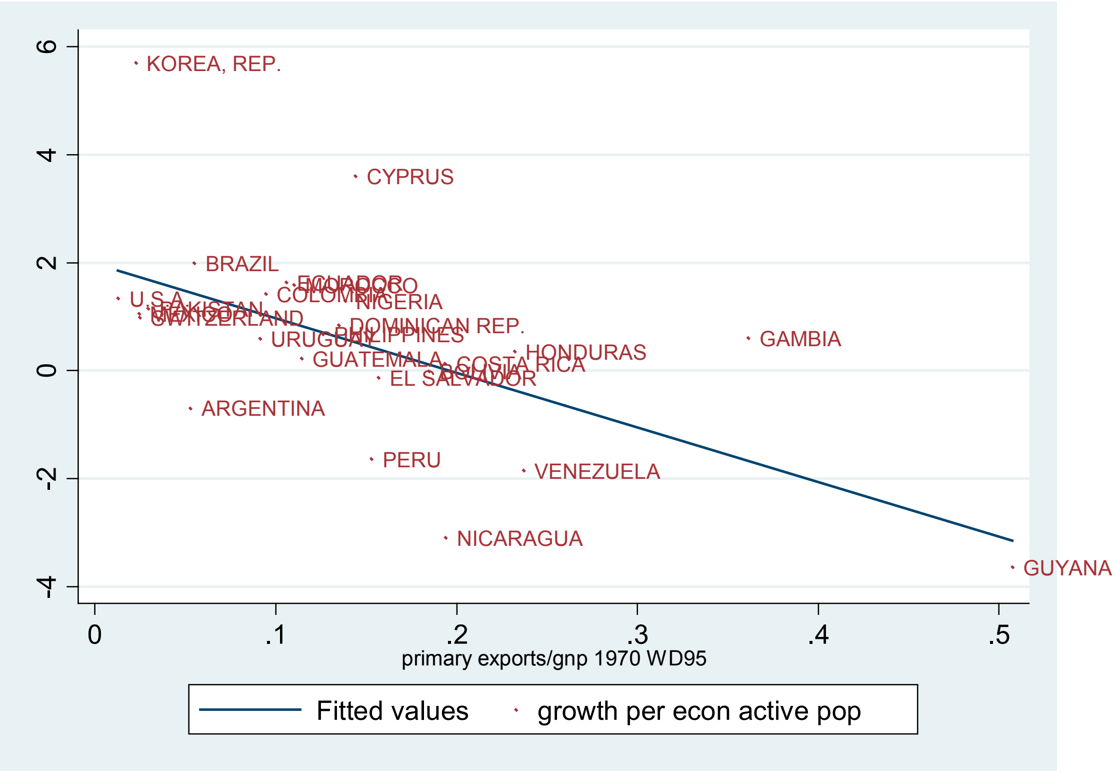
- Democracy versus autocracy

- Checks and balances or not?

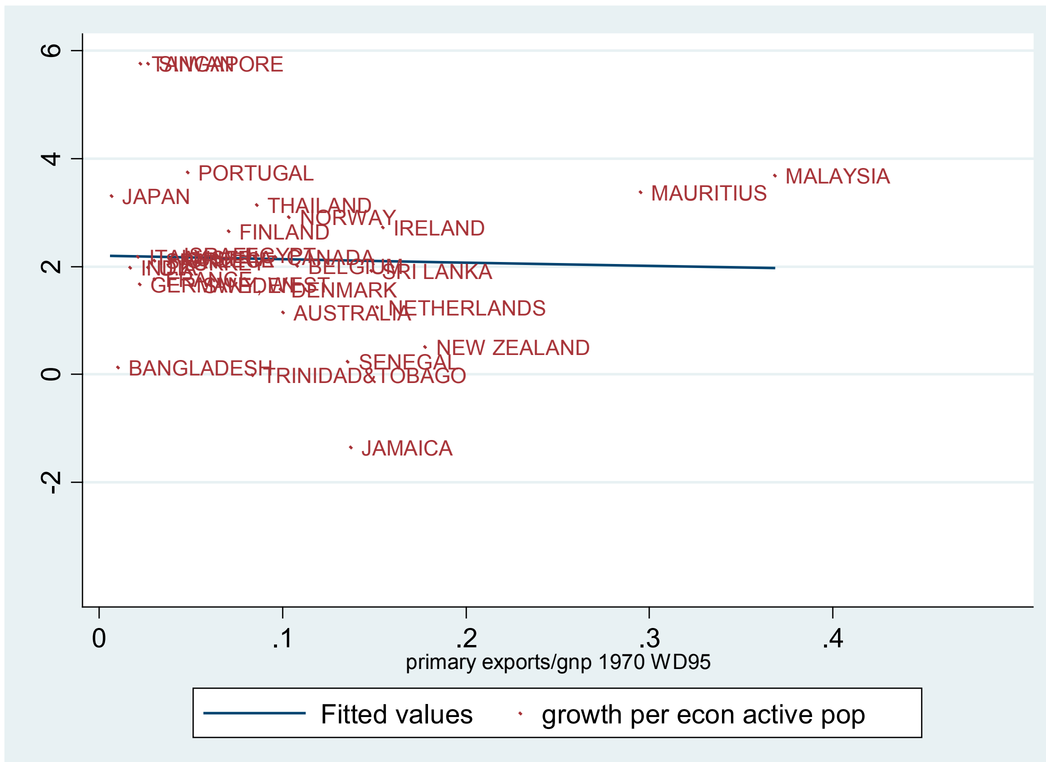


KOREA, REP.
CYPRUS
BRAZIL
NIGERIA
U.S.A.
SWITZERLAND
DOMINICAN REP.
GAMBIA
HONDURAS
GUATEMALA
COSTA RICA
EL SALVADOR
ARGENTINA
PERU
VENEZUELA
NICARAGUA
GUYANA
SINGAPORE
PORTUGAL
MALAYSIA
MAURITIUS
JAPAN
THAILAND
NORWAY
IRELAND
FINLAND
CANADA
SRI LANKA
DENMARK
NETHERLANDS
AUSTRALIA
NEW ZEALAND
BANGLADESH
TRINIDAD&TOBAGO
JAMAICA
primary exports/gnp 1970 WD95
Fitted values
growth per econ active pop

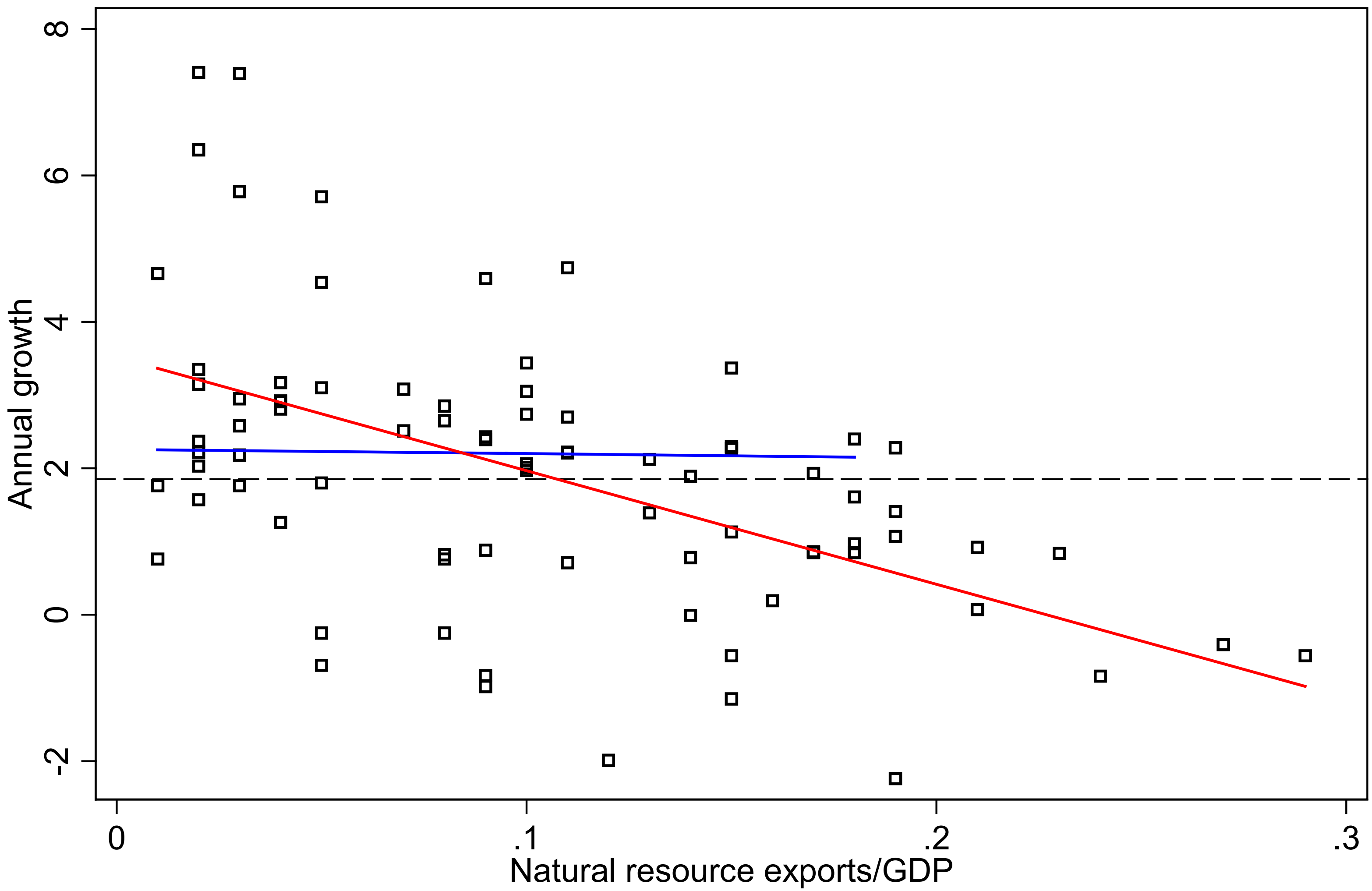
Democratic countries with presidentialism



Democratic countries with parlamentiarism



Institutions and the resource curse



Taking stock

- So reform that allows powerful groups to be checked by the rest of society is crucial

- It is a necessary
  - but not a sufficient condition
  - for resource wealth to induce prosperity:

Petroleum funds

- Question #1: How shall payments into the fund be organized?
- Question #2: How shall the fund be managed?
- Question #3: How shall payments out of the fund be decided?

Policy design in three oil economies

	Payments in	Management	Payments out
Alberta Heritage Fund	Discretionary 30% →15%→0%	Political investment commitee	Discretionary Target: Not above 5% of the fund
Alaska Permanent Fund	Rules (part of constitution) At least 25% of royalties (10-15% of oil income)	Independent company Majority of private persons in board	Rules (part of constitution) 21 % of net profits last five years
Norwegian Petroleum Fund	Guidelines 100%	Unit in central bank (delegated from Ministry of Finance)	Discretionary Target: Not above 4% of the fund

Experiences – payments in

- With the exeption of Alberta payments into the funds have been in accordance with the intentions

- The simplest and most transparent set-up is probably to channel all the petroleum revenues into the fund

- In any case year to year discretionary decisions should be avoided

Experiences – management

- Alberta Heritage Fund – heavily critizized
- Norwegian Petroleum Fund – good
- Alaska Permanent fund – good

Experiences – payments out

- Alberta Heritage Fund – massively overuse
- Norwegian Petroleum Fund – slightly overuse
- Alaska Permanent Fund – in accordance with rules

So is Alaska the perfect solution?

…..unfortunately not:

Petroleum funds

- Rules have a cost – reduced flexibility
- Must be integrated and coordinated with macroeconomic policy
- Best international practice can be improved