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Mineral Rents and the Financing of Social Policy: *Options and Constraints*

Mineral wealth is not a curse but an economic opportunity. UNRISD research suggests that when countries carefully balance productive and redistributive goals, mineral wealth can be harnessed for equitable and sustainable development. To manage the challenges of a mineral-led growth path successfully, countries need to design and implement comprehensive, inclusive and rights-based social policies; build strong democratic institutions; and be given the policy space to foster productive diversification while safeguarding macroeconomic stability.

Mineral rents and revenues from commodity sectors have fuelled growth and enabled the expansion of public expenditures in a number of countries. Yet there is disagreement about whether a mineral-led development path is a blessing or a curse, especially in resource-dependent developing countries.

Fiscal Space

Resource-rich developing countries do not suffer the same constraints as resource-poor countries in providing comprehensive social policies

Policy debates about the prospects for implementing and expanding social policies in developing countries tend to emphasize constraints related to cost and affordability. It is often argued that poor countries cannot afford universal public services such as health and education, or cash transfer schemes, due to a lack of fiscal resources and contributory capacity of the poor.

This constraint has become even more binding in the context of globalization and the recent global economic crisis. At the same time, there is growing recognition that access to social services is good not only for human well-being but also for economic growth, and that expansion of social protection is urgently needed to help people cope with market volatility, processes of demographic and structural change, and the changing circumstances of life.

> **Transformative social policy**
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> Transformative social policy has multiple functions and affects social welfare, social institutions and social relations. It is concerned with production, reproduction, protection, and redistribution and contributes to normative goals such as democracy, equity, social inclusion and rights.

The Potential of Mineral Rents

Many of today's rich countries have sustained development with the help of mineral rents

Rents from mineral extraction can play a role in fostering social development and funding social policies in poor countries characterized by limited fiscal resources, widespread poverty, inequality, and lack of decent employment opportunities. Mineral rents have been utilized by many countries to initiate, develop and sustain their economic and social development. Rich countries such as Australia, Canada, the Nordic countries and the United States started as producers of primary goods from agriculture, fishing, forests or minerals. Revenues from commodity production helped fuel growth processes and allowed for expansion of public expenditures in these countries.

A Blessing or a Curse?

Despite resource abundance, and favourable commodities prices, mineral wealth is regarded by many as a curse

Many of today's developing countries are producers and exporters of primary commodities, and some have recently uncovered vast mineral deposits. This opens a window of opportunity for these countries to take advantage of rising international demand, sustained in part by the resource-hungry Asian giants China and India.

If the international context is favourable for commodity exporters, how can resource rich developing nations grasp the opportunity and channel revenues from their natural resources towards improving their people's well-being and living standards? Despite widespread recognition of the revenue potential of natural resources, there is disagreement about whether a mineral-led development path is a blessing or a curse, especially in view of the long-term development and growth prospects for resource-rich countries.

While natural resource endowment was viewed positively in early economic thinking, the resource curse thesis argues that easy access to rents can hamper economic growth through reinforcement of structural, monetary and policy constraints in the development process. The argument runs that in the longer term commodity prices tend to decline vis-à-vis manufactured goods (the famous Prebisch-Singer thesis); that the mineral sector often constitutes an enclave with few linkages to the rest of the economy; that it hampers productive diversification and macroeconomic stability through Dutch disease effects (inflation and currency overvaluation induced by foreign exchange inflows) and reinforces multiple inequalities; that it creates incentives for rent-seeking behaviour and excessive state intervention; that it can even fuel violent conflict; and that both volatility of revenues and the depletable nature of mineral deposits create problems in terms of sustainability and long-term planning.

Research Findings

UNRISD research findings challenge the deterministic view of the resource curse literature without denying the policy challenges associated with mineral-led development. In mineral-rich countries that performed more successfully, the state played a strong role. These countries have also tended to make use of economic policies that provide incentives for productive investment and diversification while safeguarding macroeconomic stability; they have shown a willingness and capacity to negotiate and establish consensus between different actors and social groups; and they have invested in comprehensive social policies.

Country context matters

It is not simply mineral wealth that determines development: it is the political-economic context of a country that shapes how successfully it manages its natural resources for economic and social development. This broader context refers to the level of development of productive structures and economic institutions and strategies before minerals or fuels were discovered; to economic policy frameworks targeted at the extractive sector and its linkages to the rest of the economy; to social and political structures; and to the international context and pattern of insertion of a country into global markets. In addition, global demand and prices, economic strategies pursued by other countries (also in a regional context), conditions imposed by creditors, new regulations and policies related to climate change processes and the role of foreign investors all have a bearing on the economic performance of these countries.

Norway is an example of an economy that benefited from advanced economic, social and political institutions when it found oil. This helped the country manage and develop the new extractive sector based on transparency and accountability and within a rules-based fiscal framework. Strong state institutions, consensus-building and the redistribution of rents contributed to stability and legitimacy and transformed Norway into the country with the highest human development level in the world. Norway is also a good example for creating synergies rather than trade-offs between economic and social policies: the Government Pension Fund created in 1990 serves both as an instrument of macroeconomic stabilization and as a pension fund for a rapidly ageing society.

Using mineral wealth to finance social policy can help build trust and cohesion

Low levels of development are not an impediment to pursuing a development strategy based on natural resources and to financing social development through revenues from mineral rents. Social policy addresses many of the problems resource-dependent countries face because it can exert a positive impact on growth, employment, social cohesion and political legitimacy.

Although social policy regimes do not appear to be directly shaped by specific funding sources such as mineral rents, the increased fiscal space afforded by mineral wealth can open up possibilities to introduce or expand social policies. In Nigeria, social policy played a significant role in earlier efforts at building trust and national cohesion, in particular in the post-civil war period, with investments in education and health being largely financed by earnings from agriculture and hydrocarbons. Lessons from Chile show that a country can go through different phases of mineral-led development and improve economic and social policies over time. The example of Chile also highlights that democracy is an important factor for channeling benefits of mineral production to the wider population, and for creating credibility and stability for foreign investment in the sector.

Carefully designed economic and social policies help deal with some of the most common challenges of mineral wealth

Dutch disease, lack of productive diversification, low levels of employment generation, inequalities, macroeconomic volatility, inefficiencies in the management of public enterprises, and lack of regulation of private investors are some of the specific economic challenges associated with mineral-led development. Some or most of these effects are visible in all countries that rely heavily on minerals, even in the more successful case studies such as Botswana, Chile, Indonesia and Norway. Manufacturing has declined in Norway; Botswana suffers from a lack of economic diversification and persistently high unemployment; Nigeria struggles with environmentally and socially induced conflicts between local communities and foreign investors; and the public oil company in Indonesia has not operated in an efficient and transparent way.

Yet some of these countries have nevertheless been able to design economic policies, social policies and political institutions to help them overcome some of the common challenges associated with mineral-led development. Chile and Indonesia implemented macroeconomic policies that reduced the effects of Dutch disease and supported diversification of the economy. In Botswana, Chile and Norway the state has a strong role in the extractive sector and has created a stable and transparent revenue system. Generally speaking, a positive economic growth scenario in mineral-rich countries has been characterized by decreasing levels of debt and current account deficits, high savings rates, a public-sector company that competes successfully with private producers in the mineral sector, sectoral diversification (including agricultural resources) with increased technological capacities, and a long-term development strategy with a strong integration of economic and social policies.

Successful mineral-rich countries have built political consensus and strengthened redistributive social policies

Research shows that countries with better social indicators and stronger economic performance are also those that have channeled revenues into social policies (Botswana, Chile, Indonesia and Norway). Sound economic policies and sustained growth alone are insufficient for social development: Indonesia's poor social indicators improved only after the implementation of more comprehensive social policies following the transition to democracy; under Pinochet, Chile accumulated considerable social debt which it started to pay off after a return to democracy and through the expansion of public social services and income transfers.

In Chile, Indonesia and pre-1980s Nigeria, the expansion of social services such as health and education, and of social transfers such as pensions, family allowances and social assistance, have had a number of positive effects: they created employment in the social sectors which contributed simultaneously to growth, poverty reduction and social development; it helped to reduce distributional conflicts; lessen gender, ethnic and regional inequalities; and contributed to social cohesion; and it contributed positively to economic development through demand stabilization and productivity increases. Chile, Indonesia and Norway also created political institutions that adjusted to changing contexts and followed a developmental strategy, ultimately moving towards stronger democratic structures.

Lack of state capacity, unequal constellations of power, and the absence of developmental economic and social policies impede the potential of mineral rents

In less successful countries, entrenched power constellations favouring domestic or foreign elites that capture rents for their private interest, macroeconomic policies that do not safeguard stability and diversification of domestic production, lack of state capacity and lack of comprehensive social policies have led to low levels of state legitimacy, social cohesion and trust.

The worse a country performs, the more it exposes itself to external influences. This reduces policy autonomy and weakens negotiating power vis-à-vis foreign investors. It invites policy conditionality by foreign creditors and generates macroeconomic instability resulting in increased debt costs and restricted access to credit. It can even lead to threats of external intervention.

Case studies from Chile and Nigeria show that development strategies based on market fundamentalism and austerity failed to translate mineral rents into positive social outcomes. In Nigeria, development outcomes deteriorated because of a combination of factors ranging from implementation of orthodox policy responses to the oil and debt crisis of the early 1980s, problems of political governance, weakness of private market actors as well as regional conflicts. Chile channelled more revenues from mineral extraction into public policies after the return to democracy, strengthened state institutions and developed more comprehensive social policies.

Implications for Policy

Build state capacity and foster positive institutional change

Public revenues generated through mineral production—ideally a combination of proceeds from state production and taxation of other producers—can provide a starting point for building state capacity that delivers on economic and social development objectives.

States should enhance their capacity to strategically mobilize and allocate resources, enforce standards and regulations, and establish social pacts through funding, delivering and regulating social services and social programmes.

There are limits to the use of blueprints for reform—each country has to create institutions and policies tailored to its unique environment, rather than transplanting generic models. Positive institutional change leading to improvements in state capacity, accountability and transparency is the result of internal processes that can result in more equitable power balances and policy outcomes reflecting the public interest.

Design policies that foster stability, diversification and equality

Good macroeconomic management of mineral production and revenues is a precondition for enabling inclusive and sustainable mineral-led development. This includes the development of fiscal rules, the creation of stabilization funds, exchange rate and monetary policies that minimize currency appreciation, as well as financial and industrial policies that foster productive diversification.

Because the enclave and capital-intensive nature of the extractive sector, as well as the distribution of revenues from mineral production tend to reinforce inequalities and are frequently associated with contestation and regional conflicts, it is important to develop a progressive fiscal covenant that compensates producing regions and communities for the social and environmental costs of mineral production and allows for more equal living standards across regions.

Channel mineral rents into comprehensive social policies

For countries that are dependent on mineral revenues, social policy is a crucial instrument to harness the development potential of mineral wealth while helping to avoid the pitfalls associated with the resource curse.

Implications for Policy, CONTINUED

Social policies based on transparent and universal entitlements and rights can contribute positively to growth, structural change, employment, political legitimacy, equality, poverty reduction and social cohesion. They can lay the foundations for a social contract that leads to a combination of better social outcomes and higher taxation compliance of citizens and investors, making social policies more sustainable in the longer run.

Investments in education, health and the knowledge economy support productive diversification in economies that are at risk of being too heavily reliant on resource extraction. These investments produce benefits for the entire economy and, in combination with social protection policies that stabilize household income and demand, lead to higher investor confidence and create an enabling environment for development.

The expansion of the social service sector can also open up employment opportunities for women and, therefore, correct some of the gender imbalances traditionally associated with mineral production.

Make foreign investors commit to national development strategies and create fair rules on global commodity markets

Developed countries should reduce tariff and non-tariff barriers to processed minerals and fuels to enable mineral-rich developing countries to foster resource-based manufacturing industries.

International commodity markets, related financial transactions, and the behaviour of multinational corporations need better regulation and monitoring.

Developing countries need policy space to implement macroeconomic tools (such as capital controls) and structural policies (such as industrial and financial policies) that allow them to maintain stability and to diversify their productive base.

Do not neglect mobilization of other domestic revenues

Governments with access to rents should not neglect domestic revenues such as taxation and social insurance contributions, which have the potential to create sustainable intergenerational and interclass linkages. These domestic resources should be strengthened, and policies designed in an equitable and progressive way, to avoid excessive reliance on revenues from the mineral sector.

Selected References

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UNRISD Research on Financing Social Policy in Mineral-Rich Countries

This brief highlights key findings from an inquiry published as Mineral Rents and the Financing of Social Policy: Opportunities and Challenges (UNRISD and Palgrave Macmillan, 2012).

The inquiry sought to understand how the challenges associated with the resource curse thesis could be best overcome. Through thematic papers and case studies it shed light on why some developing countries are more successful than others in harnessing the development potential of their natural resources. Research systematically analysed the relationship between mineral wealth and revenues, social policy decisions and social development outcomes in developing countries. Drawing on case studies from Botswana, Chile, Indonesia, Nigeria and Norway it explored the conditions that are likely to contribute positively to democracy, social inclusion and economic development in mineral-rich countries.

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Research Continues

UNRISD continues research in this area with its project, the Politics of Domestic Resource Mobilization, which began in 2012 with the support of the Swedish International Development Cooperation Agency (Sida).

See www.unrisd.org/pdrm for more information.

About this Brief

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