CENTRE FOR THE FUTURE STATE

How do natural resource revenues affect the quality of public spending in developing countries?

Over the last decade many poor countries have seen huge increases in revenue from the export of oil, gas and minerals as a result of rising global commodity prices. Although this income provides a significant opportunity to reduce poverty and inequality, public spending in affected countries has often been unproductive. Competition for resources can also catalyse new forms of social and economic conflict.

Centre for the Future State research explored the experiences of Ecuador, Bolivia and Peru in managing the boom in natural resource revenues between 1995 and 2008. All benefitted from windfall revenues from the export of their main commodities: oil in Ecuador, minerals in Peru and gas and oil in Bolivia. The research considered the political and institutional arrangements in place prior to and during the boom and their impact on strategies adopted for allocating and managing natural resource revenues.

It was apparent that pre-existing political and institutional features, and not only policy prescriptions, affected the impact of the revenue windfall, of fiscal shocks and of formal mechanisms introduced to manage resource revenues.

Key messages for policymakers

Formal mechanisms for revenue management do matter and can potentially improve the governance of natural resources. However, it is important to take sufficient account of the existing institutional and political context into which they are introduced. Failure to do so can limit the effectiveness of reforms or exacerbate underlying problems.

The resource curse

The so-called 'resource curse', whereby resource rich countries are often blighted by authoritarian regimes, corruption and inefficiency and poor growth and macroeconomic imbalances, has been well documented. Non-tax sources of revenue, such as those gained from natural resources, erode government's incentives to remain accountable to their citizens' policy preferences and spending priorities. 'Horizontal' accountability between the executive and other branches is also undermined as governments face incentives to make discretionary use of unearned revenues and bypass the checks and balances from control authorities or opposition parties.

An important concern for mitigating the detrimental effects of the resource curse has been to avoid pro cyclical spending, through the adoption of stabilisation or savings funds to protect natural resource windfalls from being used for political gain. More recently international institutions have recommended measures including decentralisation of government, an increased role for direct citizen participation in the allocation of resource revenue, and greater cooperation between state agencies and commercial organisations in the form of public-private partnerships.

The importance of pre-existing political and institutional factors

Comparative research in Bolivia, Ecuador and Peru demonstrates the influence of pre-existing political and institutional factors on the management of revenue from natural resources. For example, in all cases, the executives were prone to centralise management of resource revenues. However, in countries where there were strong political actors at the sub national level, governments were required to negotiate the allocation of revenues with different levels of government, bringing greater accountability to the process. Conversely, where decentralisation processes had been short lived, or the political opposition had lost credibility, presidents had greater ability to dominate redistributive coalitions and to freely decide on the allocation and execution of resource rents.

At different points in time, all three countries adopted some kind of mechanisms to mitigate, in an implicit or explicit manner, the ‘resource curse’ and improve management of natural resource revenues. Such mechanisms included fiscal decentralisation schemes, stabilisation funds and revenue sharing formulas. The research demonstrated that institutional and political considerations helped to explain the success –or otherwise- of these mechanisms. For example, the timing and depth of decentralisation reforms was critical in shaping the influence of regional interests in the management of resources. Similarly, communication between policy actors across different levels of government (national, regional and local) was key to harmonising the use of natural resource revenues.

Management of natural resource revenues in Peru

The Peruvian example illustrates the importance of taking political and institutional context into account. In Peru, the implementation of best-practice recommendations exacerbated pre-existing social and institutional problems and appears to have resulted in poor quality spending, increased socio-economic inequalities between regions and spreading social conflict in both mining and non-mining areas. Despite the measures introduced, the increased revenue from mining has had little impact on poverty.

The Peruvian government adopted orthodox policy prescriptions in accordance with the advice of international financial institutions, including an ambitious programme of political and fiscal decentralisation. Revenue sharing formulas were put in place to automatically transfer a significant part of mining tax revenues back to mining and non-mining areas. However, as a result of the political context, the reforms did not operate as anticipated.

Local politics in Peru are competitive but fragmented, without strong political parties or well-defined regional interests. Although central management of public finances was competent, coordination between national, regional and local level government was poor. This undermined efforts to improve revenue management, for example through decentralised participatory budgets. Local governments lacked the capacity to manage the huge increases in revenue resulting from the system of automatic transfers.

In addition, new political actors and interests emerged at the local level through public private partnerships with mining companies. This further complicated coordination and gave rise to new tensions. The increase in local level conflicts around mining operations constitutes a significant threat to political stability.

In the context of weak central government and even weaker local government, the policies adopted have partially relocated the 'resource curse' to the sub-national level.

Further reading

Albornoz, V. and Mejia Acosta, A. (forthcoming) *Healthy Slaves: Natural Resource Boom, Budget Coalitions and Municipal Spending*, IDS Working Paper, Brighton: IDS

Arellano-Yanguas, Javier (2008) *A Thoroughly Modern Resource Curse? The New Natural Resource Policy Agenda and the Mining Revival in Peru*, IDS Working Paper 300, Brighton: IDS

Mejia Acosta, Andres (forthcoming) *The Politics of Natural Resource Management: A Comparative Study of Three Andean Countries*

Mejia Acosta, Andres and Renzio, Paolo de (2008) *Aids, Rents and the Politics of the Budget Process*, IDS Working Paper 311, Brighton: IDS