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The Political Economy of Stabilisation Funds: Measuring their Effectiveness in Resource-Dependent Countries

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The paper offers an effort to define, measure and statistically analyze the factors that explain effective stabilisation funds. While the paper confirms the suspicion that stabilization funds are not the panacea for protecting resource dependent economies from the volatility of commodity prices or ensuring long term investment, it suggests that successful stabilization funds occur where the state is able to enforce the rule of law and protect democratic liberties.

Introduction

The recent boom in the prices of commodities, such as oil and copper, has provided a revenue windfall for several countries around the world, many of which are developing countries without mature democratic institutions and which are reliant on a single export product. The implication of these increased commodity prices are increased non-tax revenues for these countries, usually in the form of royalties and licensing fees. The well-documented resource curse theory has shown that countries with a reliance on natural resources tend to have a poorer economic performance than countries with more diversified economies.

The Resource Curse and Fiscal Policy

The historical economic performance of resource-rich countries is grim. Growth tends to be slower than that of countries with more diversified economies; volatile international commodity prices make long-term fiscal planning more complex; pro-cyclical policies lead to overheated economies, increased deficits, and unsustainable fiscal positions. Dutch disease affects competitiveness and export diversification. Large infrastructure projects are poor investments or a facade for stealing from government coffers. Rent-seeking behaviour creates vicious cycles of corruption and capital evasion, and fuel military spending and civil wars but poverty remains unattacked.

A resource flow which is not explicitly linked to the domestic political or economic process, but is rather determined by exogenous factors (the international price of natural resources), induces uncertainty in the budget process, as revenues from year to year are not guaranteed and can vary widely. The more that the government revenue is dependent on the resource, the higher the volatility it can experience, which makes budgeting more complex. Another regular feature of resource-dependent countries is the existence of pro-cyclical fiscal policies, leading to increased expenditures during boom periods in which commodity prices are high. A resource boom increases expectations and contributes to the fomentation of projections of higher future income. This, in turn, leads to more political pressure to increase spending. These additional expenditures have subsequently proved to be difficult to rein in during bust cycles, thus leading to increased deficits, debt stocks, and sustainability concerns.

Measuring Stabilisation Funds Success

One measure which several resource-rich countries have taken to try to avoid the problems outlined above has been the establishment of resource stabilisation funds. Although varied in shape and form, these funds have generally been used to decrease volatility in the government budget and to save some revenues for a rainy day or for future generations to benefit from proceeds from non-renewable resources.

It is argued in this paper that the success of a stabilisation fund should be defined by its impact along three dimensions: fiscal revenues, fiscal expenditures, and savings. A new indicator – *success* – is measured based on these components of stabilisation fund success. The paper empirically tests the impact of different attributes of stabilisation funds and some political economy variables on the observed *success* of these funds. The data cover 12 countries with stabilisation funds over a 15-year period from 1992-2006. Preliminary findings show that stabilisation funds have generally been effective instruments for resource-dependent countries which sought to stabilise budget transfers from resources and save funds for future generations. Although the evidence is mixed, countries which set up these instruments have improved their fiscal position – government balances have increased by four percent and public debt has decreased by 17 percent of GDP, on average. The success of funds was associated with the presence of higher rule of law indicators, and respect for civil liberties indicators.

Policy Implications

Although there have been high expectations surrounding stabilisation funds and their ability to increase transparency and accountability, they have not been a panacea for fiscal success. Increased resource revenues lead to increased political pressures for more spending. Whether due to poor design or lack of opposition, stabilisation funds have been vulnerable to political discretion, and been drawn down to finance larger budget deficits, or even personal foreign accounts.

Where a country chooses to launch a stabilisation fund, its structures must be clearly-defined to allow for transparent functioning and for horizontal and vertical accountability in its operations. Transparency is crucial to the functioning of stabilisation funds, as it decreases the chances of rent-seeking behaviour. Furthermore, a stabilisation fund should be integrated as a virtual fund into the budget, and assurances of its integrity should be included in the design, such as the existence of periodic independent third-party audits. Transparency and regular audits of stabilisation funds and of the general public sector has the added benefit of providing additional information for credit rating agencies, which may lead to investment rating upgrades for resource-dependent countries. This could allow these countries to receive higher foreign investment, as well as have easier access to international capital markets in more favourable terms.

Future Research

Future research is required to properly address the following questions: does political stability matter more than the political system itself? If so, can there be a detrimental impact of open political systems on stabilisation fund success? What is the optimal size of a stabilisation fund? How are the benefits of stabilisation funds allocated among stakeholders and what impact, if any, does it have on poverty reduction? The literature could also be enriched with the presence of more and more complete data, especially for funds that are been long established. Finally, similar applied research could be carried out to examine the impact of similar fiscal mechanisms on the effectiveness of aid for aid-dependent countries.

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