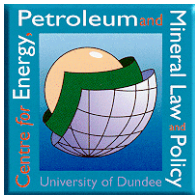


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Adding public value: the limits of corporate responsibility
Drivers of change in government behaviour
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THE NATIONAL CENTRE FOR
BUSINESS & SUSTAINABILITY



**Share of rents in 1994 GDP and GDP
Growth 1985-97** (World Bank 1999)

Resource endowment	GDP.pc growth 1985-97	Total rent (% GDP)	Pasture & Cropland rent (% GDP)	Mineral rent (%GDP)
Resource Poor				
Large	4.7	10.56	7.34	3.22
Small	2.4	9.86	5.41	4.45
Resource Rich				
Large	1.9	12.65	5.83	6.86
Small, non-mineral	0.9	15.42	12.89	2.53
Small, hard mineral	-0.4	17.51	9.62	7.89
Small, oil	-0.7	21.22	2.18	19.0
All Countries		15.03	8.78	6.25

From Richard Auty's presentation at the workshop

Summary

Contrary to most economic growth theory, some, but not all, natural resource abundant countries grow more slowly than countries less well endowed with natural resources. A theoretical construct based on the effects of rents on political behaviour is summarised here which may help to explain some of these differences. Additionally, the popular hypothesis that 'good institutions' explain differences in outcomes across NR abundant countries is discussed and challenged with a case study on Chile. Finally, oscillating international ideological shifts between an emphasis on market failure and state failure, together with the influence of economic and political conditions, are identified as important variables in explaining recent shifts in policy stance.

Background

On average, natural resource abundant economies have grown more slowly than economies without substantial natural endowments. For instance, slow growing economies, such as Angola, Nigeria, Sierra Leone, Saudi Arabia, Venezuela, and Zambia, are all resource rich, while the Asian Tigers, Hong Kong, South Korea, Singapore and Taiwan, are all resource-poor. This is surprising from the perspective of most growth theory given that the income and foreign exchange generated from natural resource extraction should lead to greater levels of domestic investment and greater opportunities to import capital, both of which should foster economic growth. However, in many countries large NR endowments have not led to an acceleration of economic growth. In some cases this is because a failure in macroeconomic policies has led to 'Dutch Disease': appreciation in the real exchange rate and declines in the competitiveness of other economic sectors, and excessive borrowing. In other cases, poor governance, in terms of rampant corruption and underinvestment in infrastructure, education and health, seems to be a major reason for what has been called the 'resource curse'.

A political economy of failed economic growth

The presence of large amounts of 'rent,' defined in this presentation as 'fungible revenues detached from the economic activity that generates it,'¹ is a major feature of many developing country economies. Together, natural resource rent, international aid and rent from government monopoly activity may comprise between 20 and 60 per cent of gross domestic product. It is argued that this has profound effects on government incentives and the development trajectory, and that this may help to explain the association between natural resource abundance and the pace and pattern of economic growth.

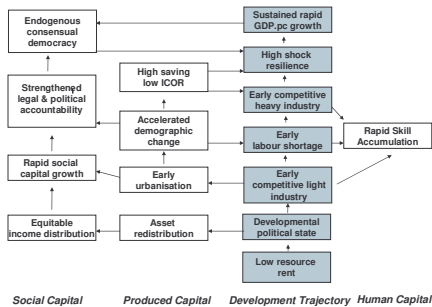
The central arguments are that

- (i) large resource endowments are likely to lead to a pattern of social-economic change which is detrimental to sustained economic growth.
- (ii) the availability of rents creates incentives for the development of predatory states which constitute an additional obstacle for sustained economic growth.

These arguments lead on to two stylised but contrasting models of socio-economic development trajectories.

¹ Economic 'rent' is more usually defined as 'the excess of the value of output over the opportunity costs of the factors involved in its production considered over the productive lifetime of the venture.'

Low-rent competitive industrialization model



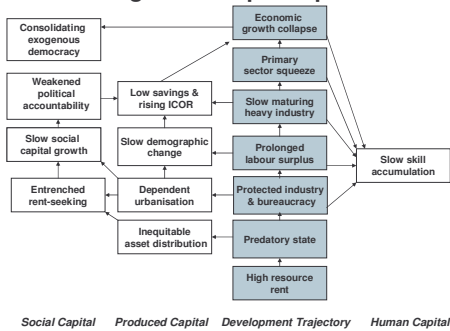
From Richard Auty's presentation at the workshop

The evolution of political accountability under low rent conditions

Type of state	Basic state aims	Critical features	Rent Pattern
Benevolent autocracy (Nation Builder)	Secure rapid GDP growth to sustain compact elite & build social unity	Low rent: external threat; poor have low opportunity cost	Low rent siphoning; efficient diffuse rent raising & dispersal
Diffusing oligarchy	Co-opt new rich into elite to deter policy capture & sustain rapid GDP growth	Low rent: intra-elite rivals; rapid egalitarian GDP growth	Low diffuse wealth extraction for public goods & (skewed) wealth creation
Consensual democracy	Growth, then equity via providing basic social entitlements	Low rent: middle class growth dilutes elite + shrinks poor	Diffuse extraction & dispersal for growth with equity

From Richard Auty's presentation at the workshop

High-rent staple trap model



From Richard Auty's presentation at the workshop

The evolution of political accountability under high rent conditions

Type of state	Basic state aims	Critical features	Rent pattern
Predatory Autocracy	Maximise elite rent siphoning, through force if necessary	High rent: violent predation, staple trap trajectory	Point source extraction by elite depresses GDP growth
Concentrated Oligarchy	Dominant faction captures policy to sustain rent + power for selves	High rent: unequal asset shares/ income, staple trap trajectory	Point extraction, but some public goods benefit mainly elite
Polarised Democracy	Capture policy to benefit tribal clients, even if retards long-term GDP growth	Democracy polarised on tribal lines: retarded GDP growth	Rent extraction + skewed distribution to tribal clients > PCGDP growth

From Richard Auty's presentation at the workshop

Low-rent states: the competitive industrialisation model

This model postulates that the limited economic potential of natural resource extraction in resource-poor countries fosters early diversification into manufacturing and competitive industrialisation. The expansion of labour-intensive manufacturing accelerates the rate of urbanisation and the demographic transition which, in turn, lead to a decline in the dependency-worker ratio. This, in turn, stimulates domestic savings and investments. At the same time, a tightening labour market creates pressure for wage increases that require further economic diversification. In summary, low resource endowments and the absence of rents create pressures for economic diversification which reduces the economy's vulnerability to external shocks.

This socio-economic development trajectory, it is argued, creates incentives for the emergence of a supportive developmental state. In the absence of large amounts of 'rent' the government needs to rely on taxation as its major source of its income. This creates strong incentives for the political elite to promote rapid economic growth and the creation of broadly-based wealth which can be taxed. The need for taxation, in turn, strengthens the relations between the state and its citizens. Citizens gain greater leverage to hold the government accountable for the way tax revenues are spent, which, in turn, reinforces the incentives for the government to align its interests with the welfare of the majority. Relatively strong state-citizen relations and the human and social capital accumulation fostered by the path of early industrialisation are favourable to the development of a democratic regime. Finally, the argument is made that democracies in low-rent countries are likely to be less polarised than in high-rent countries because early industrial development contributes to greater income equality.

High-rent states: the staple trap model

Under this model, the greater economic potential for resource extraction high-rent states retards economic diversification and industrialisation. It delays the rate of urbanisation and demographic transition. The dependency-worker ratio remains high. Furthermore, surplus rural labour persists longer with adverse effects on the accumulation of human and social capital and the equal distribution of income. If industrialisation does occur at a later stage, it does not generate the same employment benefits as early industrial development because late industrialisation tends to be more capital intensive. It may also reduce the competitiveness of the manufacturing sector.

Furthermore, the model suggests that in many resource- and rent-rich countries, the adverse effects of late industrial development have been aggravated by the development of predatory states. According to the staple trap model, the correlation between large resource endowments and predatory states is not coincidental. Rather, the availability of rents from resource-extraction provides incentives for governments to develop predatory habits.

More specifically, it is argued that the availability of large amounts of rental income has three main effects on the political economy. First, as a form of revenue that is detached from the economic activity that generates it, rent elicits contests for its capture among political elites and so can be a destabilising factor in a country's political and economic system.

Second, the availability of rents makes the government largely independent of taxes as a source of revenue. As a result, the political elite in high-rent states do not need to align their interests with the social welfare of its citizens. While governments of resource-poor countries need to pursue the creation of broad-based wealth in order to secure their income and, ultimately, their political power, the income and power of resource-rich states depends on their access to rents. Unlike the industrial development of resource-poor countries which, according to this model, follows a mainly economic rationale and takes place largely without government intervention, the socio-economic development of resource-rich countries is strongly shaped by political preferences. In order to serve their clientele, governments of resource-rich countries transfer rents from the primary sector into an expanding and often inefficient non-tradable sector which includes slow-maturing infant industries and a bloated public sector. As the political clientele expands, increasing demand

for rents puts ever more pressure on their extraction from the primary sector, which reduces the investments necessary to expand production and to improve competitiveness. The economy becomes locked into a 'staple trap' in which the government and its clientele depend on a primary sector characterised by declining competitiveness and a shrinking contribution to GDP.

Third, the model suggests that the government's independence of taxes, and thus of its citizen's wealth, affects institution building negatively and the development of strong reciprocal relations between the political elite and its citizens. The government has little incentive to provide public services or the institutional environment for economic development, while citizens have weak incentives and little leverage to hold the government accountable. Combined with a skewed income distribution, and resulting social tensions, this scenario presents poor prospects for the endogenous development of a consensual democracy.

Two country case studies

Although highly stylised, the 'high-rent staple trap model' may offer some insights into the socio-economic development of many resource-rich but low-growth countries such as Angola and Nigeria.

Angola

After Independence the bulk of oil rents financed the military and subsidised the income of a small urban elite. The costs of the war, itself largely an armed competition for oil rents, and rising demands from the urban elite, outstripped the value of rents and resulted in a fiscal deficit. This was monetised resulting in rising inflation and an appreciation in the value of the currency. In the 1990s the IFI encouraged macroeconomic reforms but these were captured by the political elite who purchased privatised SOEs to secure local monopolies. They were not only indifferent to reform but increasingly insulated themselves from IFI influence.

In 2004 multi-billion dollar loans were raised using oil rents as collateral, further reducing dependency on the IFIs and their influence. Meantime, there had been a three-fold increase in the real exchange rate since 1993. Agriculture remained neglected, stagnant and no longer competitive although it employed more than 80 per cent of the workforce.

Nigeria

In Nigeria, oil revenues are controlled by the public sector and represent an estimated 37 percent of GDP and 63 percent of consolidated government revenues. Various Nigerian governments have used the oil revenues to hold together a fragile political coalition of diverse ethnic and religious interests. However, oil revenues have been a source of conflict among different elites who have fought over rents as a means to attain and secure power through political patronage. The economic effects of political instability have been aggravated by macro-economic mismanagement. During oil booms, public expenditure spiraled out of control, creating considerable macro-economic instability. Economic adjustment policies have typically followed but were not maintained against the opposition of vested interests. While rampant corruption has benefited a small elite, overall economic growth has been stagnant. Annual per capita income is estimated to have fallen from about US\$ 800 in the early 1980s to about US\$ 300 today.

The 'high-rent staple trap model' may also shed light on some of the difficulties the current government under President Obasanjo faces in its efforts to reform the public revenue management. The national oil and gas objectives set by the government require improved governance and a transparent environment for the huge investment needed. In order to re-engineer the public perception of the institutions, systems and procedures for the management of revenues derived from minerals extraction, Obasanjo's government launched the Nigerian Extractive Industry Transparency Initiative (NEITI) which went beyond the global framework of the EITI and implemented the most comprehensive transparency audit of the energy sector ever to be conducted. The audit highlighted

weaknesses in the way Nigeria has operated its oil and gas sector, notably with respect to accounting control, capacity constraints in regulatory agencies and data availability.

Nigeria has made significant progress in implementing public revenue reforms. However, they have been largely driven by President Obasanjo and it remains uncertain whether they have been anchored well enough within a durable institutional framework to survive his presidency. Furthermore, that progress that has been made is mainly at the national level. However, much of the oil economy is located at the state level and controlled by state level elites who derive their political power from access to the oil rents. Obasanjo's attempt to introduce greater transparency into the oil sector will impact strongly on the local political economy. As a result, local elites are likely to present a major obstacle to the implementation of further reforms.

Institutions and government behaviour

While a political economy theory based on a 'high-rent, staple trap model' may provide an explanation for poorly performing countries, it has difficulty explaining why some governments of resource-rich countries such as Norway, Chile and Botswana have implemented policies which have been conducive to long-term economic growth.

Institutional theory seeks to explain these variations by focusing on differences in the formal and informal rules that govern human, and particularly political, behaviour. The underlying idea is that certain institutions provide incentives which encourage rent-seeking behaviour, political patronage, and corruption while others provide incentives for political actors to restrain these selfish behaviours and to use natural resource revenues to accelerate economic growth and to encourage economic diversification. However, this may not be the whole story and the issue of institutional change is certainly more complex than a simple distinction between good and bad institutions.

The case of Chile

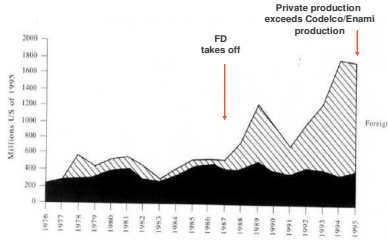
One frequently cited success-story of a resource-rich country is Chile. Despite considerable mineral wealth, Chile has not only completed a successful transition from autocracy to democracy, but it has also outperformed other resource-rich countries in economic and social indicators.

At first glance, the history of Chile's socio-economic development seems to correspond to institutional changes in the governance structure of the country. Liberal economic policies and FDI-friendly legislation introduced since the early 1980s as well as greater emphasis on social policies in the 1990s seems to have laid the foundation for macro-economic stability, economic growth and the reduction of poverty by almost 50 percent during the 1990s.

However, closer examination suggests that Chile's is not a straightforward story of 'good' institutions providing the 'right' incentives for economic growth. In some areas, such as trade liberalisation and the promotion of FDI, the government followed neo-liberal notions of 'good,' that is, growth-promoting, policies. However, in other areas Chile's government deviated considerably from such ideas. For instance, domestic mining companies were not privatised but remained in state ownership and under the control of politically appointed boards. The government's decision not to privatise the domestic mining sector secured a major source of income for the government in the form of tax. Until recently, tax from the domestic, state-owned firms far exceeded tax revenues from privately-owned multinationals.

Chile's socio-economic development over the 25 years can certainly not be fully explained by reference to the incentives provided by 'good institutions'. The notion of 'good institutions' is generally problematic; first, because of its normative bias, and second, because it assumes a quasi-mechanical link between certain kinds of institutions and a specific form of political and economic behaviour.

Investment in Chile's copper mining



Investment in copper mining: foreign and Codelec + Enami. Source: Codelec and Enami and Foreign Investment Committee (1995).

From Evelyn Dietsche's presentation at the workshop

How much do 'good institutions' really matter'?

In popular language, the term 'good institutions' usually denotes policies and legal frameworks assumed to determine the smooth operation of a free market economy and fiscal stability. These include the protection of private property rights, the rule of law, low levels of corruption, and fiscal stability. The term 'good institutions' is frequently used to promote a specific notion of social, political and economic order. However, this usage is distinct from the concept of 'institution' as an analytical tool for the study of human behaviour in the social sciences, including not only economics but also political science and sociology. Here, institutions are defined as "the rules of the game in a society [...] the humanly devised constraints that shape human interaction"². In this case, no *ex ante* assumptions are made about a certain kind of institutional arrangement or policy and a specific form of human behaviour. This dual use of the term is problematic. The popular dichotomous distinction between good and bad institutions has at worst undermined the analytical value of the concept.

What about institutional change?

If the link between institutional design and human behaviour is complex and rather unpredictable it casts doubt on the idea that government behaviour can be purposefully altered through institutional reform. Moreover, even if there were a direct link between institutions and human behaviour, very little is known about how social institutions are constructed and re-constructed. That is, even if the institutional conditions that make for good social and economic development were known, much remains to be learned about how those institutional arrangements can be achieved in practice.

The main challenges are that different institutional arrangements can lead to similar outcomes and the process of institutional change over time and the interdependent economic, political and social forces that drive it remain an understudied subject.

Additional influences on government behaviour

Government behaviour is influenced by both internal and external conditions. Political cycles, economic conditions and ideological swings have been identified as important variables to explaining how NR revenue is managed.

Political cycles

Domestic political cycles often correspond to the government's life cycle. For instance, political instability or imminent changes of government may provide strong incentives for political elites to purchase patronage with EI revenues. In democracies, electoral cycles are important modifiers of political behaviour. On the hand, one could argue that democratic regimes strengthen incentives for the government to manage NR revenues in the public interest. On the other hand, electoral cycles are typically shorter than the time required to realize the benefits of public investments. This may equally strengthen the incentives to use NR revenues to secure the support of the government's constituencies.

Economic conditions

Countries' economic position is only partly under policy control as it is also influenced by internal and external economic conditions such as the structure of the domestic economy, prices in world markets and exogenous shocks. Governments react to such conditions in various ways. For instance, policy volatility may partly be the result of volatile terms of trade and consequent volatility in public revenue.

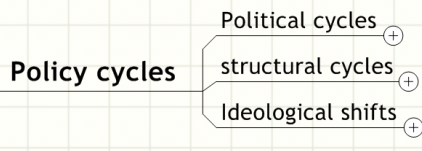
Ideological swings

The decline of socialism and the rise of the market as the dominant mechanism for allocating resources have resulted in profound changes in the way NR revenues are managed. There is some evidence for the 'contagion' effects between countries of

² North, D. C. (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, Cambridge, U.K., p.3.

D. C. North, 2001:

"The problem is straightforward. We know both the economic conditions and the institutional conditions that make for good economic performance. What we do not know is how to get to them"



From Thandika Mkandawire's presentation at the workshop

ideological positions underlying NR management in a geographical region. While the 1950s and 1960s saw the nationalization of the EI sector in many countries, the 1970s and 1980s witnessed the rise of neo-liberal ideas and the consequent privatization of many state-owned companies. Most recently, one can observe the influence of populist ideology on NR management in some Latin American countries.

At the same time developmental ideologies have shifted, leading but more often reflecting these changes. While in the 1950s and 1960's the emphasis was on market failure leading to a preference for state planning and Keynesian economic management, in the 1970s and 1980s economic analysis based on public choice theory and principal agent analysis emphasised government failure. Most recently problems of market failure have reasserted themselves with an increasing recognition of the fundamental need for a capable state and a resurgence of 'resource nationalism' implying more government intervention and greater government control over natural resources. However, this does not nullify the risk of government failure or the dangers of a predator state.

Conclusions

Both institutional theories and models focussing on structural links between a country's political economy and patterns of socio-economic development shed light on important factors driving government behaviour. The explanatory power of such theories may be strengthened by considering the contribution of other factors such as ideological shifts, political and structural cycles, and the state-society nexus in explaining changes in government behaviour. For instance, there is evidence to suggest that the political construction of a 'vision' or a national consensus about the use of resource income has been an important factor for the economic success of some resource-rich countries.

Much more needs to be known about the way institutions conditioning political and bureaucratic behaviour develop and can be stimulated to develop, the likely outcome of changes and the mode of such change.

More research is also required into the question of how international factors can operate as drivers of change in government behaviour and how they intersect with domestic political dynamics. For instance, international organisations can encourage change in government behaviour through sanctions and aid conditionality but also through the promotion of international norms. However, the success of such initiatives depends crucially on how whether they are able to reinforce changes in the domestic political economy. How this dynamic works can be illustrated by the Extractive Industries Transparency Initiative (EITI) in Nigeria. The EITI presented a combined effort by governments, international organisations, NGOs, and some companies to promote transparency as an international norm. Primary targets of this initiative were countries like Nigeria which had suffered most from the resource curse. However, the explanation of Nigeria's position as a leading pilot country in the EITI must include President Obasanjo's leadership. In his second term in office, Obasanjo had embarked upon the reform of the extractive industry sector. The international attention to greater transparency served as a facilitator for what was essentially a domestic political project.

Finally, more research is required into the question of whether and how transnational corporations (TNCs) operate as drivers of change in government behaviour. Given the significance of TNCs for the revenue of some governments, one might assume that this would translate into political influence. However, the role of TNCs as drivers of change in government behaviour appears to be limited by at least two factors. First, TNCs unite much more easily on operational issues than on social and political issues. This means that their influence is limited by the fact that they usually act unilaterally in this area.

Second, TNCs are very cautious about any engagement in social and political activities that might endanger their relations with the authorities. The example of Nigeria illustrates this point. It was only after the President had formally backed the EITI that the TNCs operating in Nigeria endorsed the scheme.

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Further reading & useful websites

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http://www.oecd.org/topic/0,2686,en_2649_33935_1_1_1_1_37405_00.html OECD Institutions, Governance & Development