

POLITICAL ECONOMY OF RESOURCE ABUNDANT STATES

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Abstract

Natural resource-abundance tends to undermine investment efficiency whereas a resource-poor endowment places a premium on efficiency. The type of political state provides the link between the natural resource endowment and the economic outcome. Developmental political states tend to be associated with resource-poor countries, albeit not exclusively so. Their governments pursue a coherent economic policy that maximizes social welfare. Resource-poor countries with developmental states industrialize early and follow a competitive industrialization model that sustains rapid and egalitarian growth. In resource-abundant countries, contests for rents generate factional and predatory states that distribute the rents through indirect means that distort the economy. The most likely result is a growth collapse, recovery from which may take decades.

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Natural Resources and the Political State

A UNU/WIDER research project finds that resource-abundance tends to undermine the efficiency of investment whereas a resource-poor endowment places a premium on efficient investment (Auty 1999). The type of political state provides the link between the natural resource endowment and the economic outcome.

The link can be analyzed using a typology of political states that is elaborated from Lal (1995) and based upon the autonomy of the state and the aims of the state. For example, an autonomous state has sufficient independence to be able to pursue a coherent economic policy, and a *benevolent* autonomous state seeks to maximize long-run social welfare. The benevolent autonomous state is associated with the developmental states of resource-poor East Asia. There are four main reasons for this. First, intense population pressure on scarce land resources reduces the tolerance of the majority of the population for inequitable land distribution and predatory rent extraction. This creates political tensions that enhance the probability that the political state will realign its interests with those of the low-income majority and redistribute assets (Auty 1997). Second, in resource-poor countries it becomes clear at a relatively low income that neither the primary sector nor competitive manufacturing can support either slow-maturing *protected* manufacturing or an over-expanded bureaucracy. Third, resource-poor countries are also less prone to trade policy closure because any Dutch disease effects (the contraction of agriculture and industry) are likely to be muted. Finally, a spartan natural resource endowment places a premium upon the efficient use of investment, especially for strengthening human and social capital.

In resource-abundant countries, the natural resource rents, particularly in concentrated form, offer a magnet for political competition. Resource abundance therefore encourages contests for the rents that tend to engender factional or

autonomous predatory political states. To stay in power, the governments of resource-abundant countries need to find a way to redistribute rents to favored groups. They tend to do so at the expense of a coherent economic policy.

Factional and predatory states tend to predominate in sub-Saharan Africa. Individual tribes or tribal coalitions channel political energy into capturing the government. Easterly and Levine (1997) find that ethnic diversity fosters rent-seeking behavior that encourages the adoption of growth-retarding policies and inhibits consensus on investment in growth-promoting infrastructure. They find that ethnic diversity is positively associated with low schooling, underdeveloped financial systems, distorted exchange rates and deficient infrastructure. Growth collapses occur despite the importance of peasant farming with its diffuse socio-economic linkages that should favor economic development (Baldwin 1956).

Factional states are also common in resource-abundant Latin America, where a landed elite sustained power long after the achievement of independence from the colonial government. When the elite was eventually displaced, it was often by new factions. Engerman and Sokoloff (1997) attribute this to a natural resource endowment whose commercial crops initially favored large estates. The initial estates shaped institutions that perpetuated inequality.

However, even where the factional state is a democracy, economic policy may still fail. Sri Lanka and Malaysia illustrate the two basic types of democracy and the effect on policy. In Sri Lanka, a *polarized* democracy traded economic growth off for income redistribution (Bruton 1992), whereas in Malaysia, a *consensual* democracy ensured that redistribution was not at the cost of long-term economic growth. The Malaysian consensus created a developmental state as a result of a political compact between the two largest racial groups (Islam and Chowdhury 1997).

Resource Rent Redistribution and Economic Distortion

One important characteristic of resource-abundant countries is the use of indirect redistribution mechanisms to allocate natural rent. Only rarely is it politically expedient (or technically possible) to use transparent mechanisms such as direct distribution to households through vouchers. Use of this method is usually confined to high-income regions with a strongly individualistic tradition (as in Alaska and Alberta). One difficulty with such a mechanism is that it opens up the prospect of an open national debate on the appropriate distribution of income and wealth that few states may be willing to contemplate. Indirect mechanisms for distributing rents can invoke other goals (such as the 'need' to build an industrial sector or the 'urgency' of creating jobs) to validate a distribution strategy that is appealing on political grounds. Direct distribution also requires that the government is willing to renounce the use of rent as an instrument for boosting its own power relative to that of its citizens—and few governments are eager to do this.

A second characteristic of resource abundance—especially relevant to mineral exporters in which a large share of rent goes directly to the government—is a chronic tendency for the state to become overextended, especially in the face of large fluctuations in the value of natural resources. Three main avenues of redistribution may be recognized, namely extended periods of protection for import-competing sectors; the creation of employment through growth of the public sector; and over-extended public expenditure. All three channels reduce the benefits of an abundant natural resource endowment.

Following the enforced industrialization of many developing countries during the 1930s and 1940s, protection was pursued on a voluntary basis thereafter. Although

the initial justification of this policy was to promote economic development, the industrial policies of most countries, especially the resource-abundant countries, degenerated into mechanisms to transfer resources from exporters. The exporters were usually in the primary sector and the transfers were to politically influential urban groups that comprised capitalists and workers together with the politicians who extracted part of the rents in return for sustaining the policy. This process of policy capture (Auty 1995) resulted in the 'infant' industries either failing to mature or taking several decades to do so. Yet Krueger and Tuncer (1982) demonstrate that maturation rates must not exceed five to eight years if the discounted benefits of the mature industries are to compensate for the discounted costs of infant industry support. Real rates of effective protection were often orders of magnitude higher than the domestic value added. Moreover, the protection tends to be ad hoc and counter-intuitive. Meanwhile, the corollary is a debilitating revenue extraction from resource-intensive sectors. Krueger (1993) finds that direct agricultural taxation in sub-Saharan Africa averaged 25 per cent, some four times that of Latin America and ten times Asian rates. The figure for sub-Saharan Africa doubles when indirect taxes, such as overvalued exchange rates are added.

Public employment can be a politically appealing way to redistribute rents. Gelb et al. (1991) develop a model of a resource-rich country whose government creates unproductive jobs in public administration and in state-owned enterprises in order to alleviate urban unemployment. A Harris-Todaro migration model determines labor flows between the rural and urban sectors. A single urban wage is assumed to hold in the three urban sub-sectors (which comprise a private sector, a productive public sector and a non-productive public sector). An exogenous rise in the urban wage (for example, due to spending the rents from a windfall or resource bonus)

creates a wage gap that raises the premium on rural out-migration. Unemployment then increases in the modern urban sector. The government responds to additional urban unemployment by increasing taxation (whose burden falls disproportionately on the private sector) in order to invest capital in the creation of extra urban jobs. But, in addition to depressing the return on investment, this process is self-defeating because it renders work in the unproductive public sector preferable to farming. More people migrate to the city, where their unemployed presence intimidates the government from which the unemployed rural migrants extract still more rent. Simulations using empirically plausible data suggest that the consumption losses grow over time and that within a decade the efficiency of capital can be depressed below the level required to sustain economic growth.

In any economic model that recognizes capacity constraints and less-than immediate clearing of markets by prices (including the labor market), the effects of chronic excess demand and deficient demand are not symmetric. Excess demand causes inflation and high import leakage; deficient demand causes real activity to contract, unemployment to rise and real incomes to fall. There is therefore a premium on maintaining spending levels relatively stable, or growing at moderate rates. This prescription is especially important for government spending, because booms tend to lock in powerful hysteresis effects that prolong high spending levels and set the stage for catastrophic macroeconomic imbalances marked by high inflation, abrupt demand cuts and sharp falls in output and growth. Over a cycle, the economy progressively moves towards stagflation. Political competition for rents, combined with non-transparent mechanisms of redistributing them (and in some cases of accounting for them), makes it more difficult for governments to moderate spending levels in response to fluctuations. With lucrative procurement contracts at stake, many projects

undertaken by resource-rich governments are valued for their immediate income-generating effects rather than their growth-enhancing potential. Moreover, with high current and potential incomes, governments face limited restraint in spending. Nevertheless, such practices distort the economy and once the distortions have been created, reform is protracted.

Stylized Facts Models of Resource-Driven Development

Two stylized facts models illustrate the developmental consequences of contrasting natural resource endowments. Although the models are not deterministic, there is a strong probability that resource-poor countries will achieve the competitive industrialization of their economies whereas resource-abundance countries risk falling into a staple trap.

The presence of a developmental state (like an autonomous benevolent state or a consensual democracy) appears to be a necessary condition for sustained, rapid and equitable economic development. There are three additional conditions, namely: relatively equitable access to land and primary education, maintenance of an open trade policy, and institutions that promote public sector accountability and efficient markets. It has been argued earlier that these conditions are most likely to hold in the presence of a poor natural resource endowment, albeit not exclusively so. Where the conditions do hold, they promote a competitive industrialization that sustains rapid and equitable economic growth.

Column 1 in Table 1 summarizes the stylized facts of the competitive industrialization model with a poor natural resource endowment and a developmental state. In resource-poor countries such governments tend to reform economic policy at a low per capita income. They abandon closed trade policies. Labor-intensive

manufactured exports expand rapidly because commodity exports are limited by the natural resource endowment. Such an expansion quickly absorbs surplus labor with three beneficial consequences for development. First, the early elimination of surplus rural labor helps to curb income inequality. Second, early industrialization accelerates urbanization so that population growth slows sooner and the ratio of dependants to workers falls earlier. This boosts the rates of saving and investment. Finally, the tight labor market requires the economy to diversify into competitive capital-intensive and skill-intensive manufacturing and this strengthens its resilience to external shocks and thereby helps to sustain rapid growth. It also helps to maintain income inequality by curbing the skill premium.

In the absence of a developmental state, natural resource abundance under factional and predatory governments provides more scope than resource-paucity does for cumulative policy error. This increases the risk that development will conform to the staple trap model, variants of which are summarized in Columns 3-5 of Table 1. A longer dependence on primary product exports means that the labor-intensive stage of competitive industrialization is leapfrogged with three adverse consequences. First, income inequality remains high and skills accumulate more slowly. Second, fears of Dutch disease and unemployment encourage trade policy closure so that manufacturing matures slowly, if at all. Third, the economy is distorted so that development relies increasingly upon commodities with declining competitiveness. Yet governments postpone reform because it is politically unpopular. Instead they either borrow from abroad or intensify the squeeze on the primary sector. Incentives in farming and mining are depressed further, competitiveness wanes and the economy becomes vulnerable to even mild shocks. Both social capital (the trust and institutions

required to lower transaction costs) and natural capital are depleted so that growth is not sustainable.

Economic growth collapsed even in oil-rich countries like Saudi Arabia that did not close their economies (Table 1, Column 5). This is because the basic policy flaw is the use of resource rents to relax market discipline so that investment efficiency declines (as the rising capital/output ratio (ICOR) in the table shows). Moreover, recovery from a growth collapse takes decades because it requires the rebuilding of economic infrastructure and social capital. Growth collapses are most acute in small resource-rich economies (whose diversification options tend to be fewer), and especially where the resource surpluses accrue mainly to the government, as in the mineral economies (and transition economies).

However, Malaysia shows that resource abundance does not preclude competitive industrialization if the political state is a developmental one (Table 1, Column 2). In this case diversification into the labor-intensive second stage of the model is retarded rather than omitted as in the staple trap model. But the growth trajectory of competitive industrialization is still modified. First, economic diversification must initially occur into other primary products. This may prove difficult for the smallest resource-rich economies whose natural resource endowment is more likely to be skewed towards the production of one or two commodities. Second, slower industrialization retards urbanization and delays the favorable middle stage of the worker/dependency cycle so that the accumulation of capital (including human capital) is slower. Third, surplus rural labor persists longer and amplifies income inequality and social tension. However, diversification may be helped by the promotion of competitive manufacturing through an export-processing zone.

Conclusion

Most economic models assume a government of adroit administrators that seeks to maximize the long-term welfare of society, whereas political economy regards these features as an ideal that is seldom realized. The developmental state may behave in the way that many economic models assume, however, because it has sufficient autonomy to sustain a coherent economic policy that seeks to enhance social welfare. This type of state is associated with a poor natural resource endowment because the absence of rents tends to reduce tolerance for inequitable asset distribution and resource misallocation, and also places a premium on effective investment. Such a state tends to resist pressures to close the economy, which adheres to its emerging comparative advantage. The economy diversifies early into competitive labor-intensive manufacturing that accelerates the accumulation of produced, human and social capital whose efficient deployment sustains rapid and egalitarian economic growth.

Contests for rents bias the political economy of resource-abundant countries towards factional states that serve sectional interests. Such governments prefer non-transparent methods for deploying the rents in order to maximize the scope for political maneuvering. The favored channels for deploying rents are trade protection, job creation and over-extended public expenditure. The economy is thereby deflected from its comparative advantage and cumulates economic distortions that retard diversification or cause the economy to regress into a staple trap of dependence on a weakening primary sector. However, resource-abundance occasionally engenders a developmental state that pursues a modified competitive industrialization path.

It is ironic that the staple trap in the resource-abundant countries resulted from the backfiring of the efforts of their governments to reduce their commodity

dependence. Domestic policies to promote infant industry (which resource abundance could sustain for longer) weakened their economies from the 1960s onwards and then international efforts to reverse the long-run decline in real commodity prices triggered trade shocks in the 1970s that precipitated economic collapses.

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Table 4 Stylised Facts of the Political Economy of the Natural Resource Endowment and Economic Growth

Model	Competitive Industrialization		Staple Trap		
Natural Resource Endowment	Poor	Abundant Diffuse	Abundant Diffuse	Abundant Point Source: Ore	Abundant Point Source: Oil
	(1)	(2)	(3)	(4)	(5)
Pre-Conditions					
Political State	Autonomous benevolent	Factional consensual democ.	Factional oligarchy/Predatory	Factional oligarchy/Predatory	Autonomous paternalistic
Income Rich 1/5: Poor 1/5	4.0 - 9.0	7.0 - 16.0	5.0 - 33.0	9.0 - 32.0	12.0 - 20.0
Obsolete Capital Stock	Low	Low	Low/High	Low/High	Low/High
Policy					
Reform Response	Early	Early	Postponed	Postponed	Partial
Trade Policy	Open	Open	Closed	Closed	Open
Incentive Bias	Comparative advantage	Comparative advantage	Infant Industry/ Public Sector	Infant Industry/Public Sector	Neutral/ Public Sector
Capital Build-Up					
Genuine Saving	Strongly Positive	Moderately Positive	Low/Negative	Low/Negative	Negative
Produced	Rapid Rise > 24%GDP	Slower Rise > 20%GDP	Slow Rise > 20%GDP	Slower Rise + < 20%GDP	Rapid Rise > 25% GDP
Human	Virtuous Circle	Slower Virtuous Circle	Lagged + Skewed	Lagged + Skewed	Rapid + Ineffective
Social	Transaction Improving	Transaction Improving	Transaction Repressing	Transaction Repressing	Feudalistic
Economic Outcome					
ICOR 1985-97	4.8	5.5	6.0	7.5	12.4
Dutch Disease Effect	Negligible	Small	Strong	Strong	Strong
Diversification	Competitive Widening	Slow Competitive Widening	Retarded/Regressive	Regressing	Mono-product
Resilience to Shocks	Robust	Robust	High Vulnerability	High Vulnerability	Financial Cushion
PCGDP Growth (%)	Sustained: 2.5 - 4.0	Sustained: 1.0 - 2.5	Erratic: 0.5 - 1.5	Boom + Bust: (0.5) - 2.0	Boom + Decline: (0.4) - 4.0
Examples					
Classic	South Korea	Malaysia	Ghana	Bolivia	Saudi Arabia
Classic	Singapore	Thailand	Honduras	Zambia	Brunei
Anomalous	Bangladesh	Myanmar	Costa Rica	Botswana	Oman

Source: World Bank (1999)