

Interview with Arvind Subramanian and Xavier Sala-i-Martin

## Tackling the natural resource curse: An illustration from Nigeria

It is well documented that most countries do not benefit from their natural resource endowments, largely because of poor revenue management. Nigeria falls squarely into this category. Between 1970 and 2000, the country's poverty rate—measured by the

share of the population subsisting on less than \$1 a day—increased from close to 36 percent to just under 70 percent. This translates into a staggering increase in the number of poor from about 19 million in 1970 to 90 million in 2000. In a recent IMF Working Paper, Xavier Sala-i-Martin (professor of economics at Columbia University) and Arvind Subramanian (Division Chief, IMF Research Department) identify and quantify the impact of the natural resource curse in Nigeria and propose a solution. Christine Ebrahim-zadeh of the *IMF Survey* spoke with them.



Subramanian: "The government should directly distribute all, or a large fraction, of the revenues that it obtains from oil directly to the people."

**IMF SURVEY:** Why is the natural resource curse occupying the attention of policymakers?

**SUBRAMANIAN:** This issue is topical and pressing. The natural resource curse was the subject of a recent workshop organized by George Soros's Open Society Institute and held at Columbia University, where a group of economists, political scientists, lawyers, policymakers, and representatives of civil society gathered to discuss ways of overcoming it.

One outcome of the workshop was to commission a project that would involve the compilation of a handbook of best practice. This handbook would cover the entire cycle of resource exploitation—from exploration to government expenditure of the revenues derived from the resource. It would provide guidance to governments on how to proceed with the exploitation of a natural resource in a manner that maximizes the benefits derived from it.

There was a shared sense at the workshop that any effort to address the curse should focus equally on the role played by foreign companies that helped exploit the resource. These companies should be subject to best practice in terms of contracting, procurement, and the transparency of their operations.

The resource curse is also in the news because of a number of other developments. The World Bank, for example, is carrying out a review of its own project

lending policies with regard to extractive industries. Civil society groups have taken strong positions on this, arguing, for example, that the Bank should cease lending to extractive industries in developing countries. Oil is also being discovered in a number of important geostrategic locations, such as the former Soviet republics. And, of course, recent events in Iraq have refocused attention on the role of oil in Middle Eastern countries.

**IMF SURVEY:** Why are some countries subject to the natural resource curse and some not? How does it manifest itself?

**SALA-I-MARTIN:** Based on cross-country evidence, we found that the natural resource curse is intrinsic to most countries with oil or minerals—that is, owning such resources depresses long-run growth. But countries that are rich in other natural resources, such as agricultural products and commodities, are not subject to the curse. Also, and more important, the curse works by destroying domestic economic and political institutions. The presence of oil or minerals gives rise to rent seeking and corruption, which adversely affect the climate for investment and growth.

But the deeper sense in which natural resources impede the development of institutions is that they minimize the two-way interaction between the state and its citizens. Political scientists and economic historians have emphasized this effect. Governments that have easy recourse to oil rents do not need to promote wealth creation that they can subsequently tax; in turn, citizens have less incentive to hold governments accountable. Historical experience suggests that institutional development is impeded because of this disconnect between governments and their people. Our research is interesting also because it suggests that other effects that are commonly thought to be associated with owning natural resources, such as revenue volatility or currency overvaluation, are less important in contributing to lower long-run growth.

**IMF SURVEY:** What is the IMF's policy prescription for preventing or addressing the curse?

**SUBRAMANIAN:** I am not sure that the IMF has a specific policy prescription for preventing or addressing the curse. The IMF routinely asks for better fiscal policy and better management of oil revenues—which, in this case, means saving during revenue upsurges to stabilize the economy as well as saving for

the future when the resource is expected to be depleted. In some instances, such as Kazakhstan, the IMF has promoted or agreed to the creation of special oil funds. Although varying in detail, oil funds are an attempt to separate and render transparent some or all of the revenues from oil, and the uses to which they are put. Research by the IMF Fiscal Affairs Department suggests that the experience with such funds has been mixed. The IMF is involved in some international initiatives, such as the Extractive Industries Transparency Initiative sponsored by the United Kingdom's Department for International Development, which aims to make oil companies and governments more transparent in transactions related to oil revenues.

**IMF SURVEY:** Why hasn't Nigeria benefited from its oil?

**SALA-I-MARTIN:** Nowhere are all the pathologies associated with oil as clearly manifest as in Nigeria. The Biafran war of secession—Africa's biggest civil war—in the late 1960s, which led to one million deaths, was in part an attempt by the eastern, predominantly Igbo, region to gain exclusive control over oil reserves. Nigeria has witnessed the assassination of two leaders, six successful coups and four failed ones, and 30 years of military rule. In past decades, Nigerian rulers may have plundered oil wealth to the tune of tens of billions of dollars. The explosion in windfall-financed government expenditures also provided increased opportunities for kickbacks. All of these factors have contributed to poor growth but also to staggeringly destructive development outcomes. Thus, oil, and the institutional deterioration that it has led to, has perhaps been the single most important cause of Nigeria's economic and political problems.

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—Xavier Sala-i-Martin

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**IMF SURVEY:** What is your proposed solution for countries at risk of the resource curse?

**SUBRAMANIAN:** Our proposal is very simple. The government should directly distribute all, or a large fraction, of the revenues that it obtains from oil directly to the people. To generate revenue to finance its expenditure, the government should rely on normal tax policy instruments—like in any non-oil country. The chief virtue of this approach is that it would minimize opportunities for corruption and misappropriation, because windfall revenue would stay out of the hands of public officials. It would also rectify the imbalance of economic and political power, which is strongly tilted in favor of the government and against the people in most oil-rich countries.

Of course, a number of practical design issues need to be addressed, such as who should get the money—adults, women, or households? How much of the revenue should be distributed? How should it be distributed? Answers to these questions will undoubtedly vary from country to country, but practical solutions can be found with some thought, ingenuity, and the involvement of domestic and international actors.

**IMF SURVEY:** How realistic is this strategy? What are its disadvantages?

**SALA-I-MARTIN:** There are two standard objections to this proposal: the risk of macroeconomic instability caused by the loss of revenue to the government; and the inefficiency involved in distributing revenues to the people only to then partially tax those revenues back to finance public investment and other sensible government expenditures.

Neither objection is really compelling. In terms of macroeconomic consequences, the proposal would essentially convert public windfall gains and losses from price volatility to gains and losses to households. Who is better at determining how much to save and spend—the people or the government? Now, in principle, an argument can be made that the government has a custodial role to play to smooth consumption and to save. But the choice almost always is whether the people or a weak or corrupt state would be better at these decisions. And the evidence clearly suggests that weak states do very badly in making these decisions. For example, a steel factory built by the Nigerian government has not produced a single ton of salable steel in nearly 40 years.

The second objection is that the proposal would be doubly wasteful because it would incur two sets of costs—first in distributing oil revenues and then in taxing these revenues to finance government needs. But we would argue that the efficiency costs are eclipsed by the benefits of encouraging public



Sala-i-Martin: "Ironically, good government and strong institutions require that the raising of public resources is costly."

scrutiny of government spending. Governments that derive revenues from natural resources like oil are in a dangerous supply-sider's paradise. That is, where the marginal cost of raising public resources is virtually zero, governments have little incentive to manage well, provide adequate public services, or respond to citizens. Nor do they have the incentive to invent and sustain the 'software' of market economies and good governments, such as institutions to protect property rights or manage redistribution conflicts. Ironically, good government and strong institutions require that the raising of public resources is costly.

**IMF SURVEY:** Do you see any hope of your proposal being put into action?

**SUBRAMANIAN:** The chances of our proposal being implemented are not bright because of a fundamental political problem. The people who are currently deriving economic and political power from access to oil revenues will fight the proposal tooth and nail. This suggests that some international intervention may be required to overcome this problem. Ideally, the chances of the proposal being implemented are greater where there is a big transition—some kind of "constitutional moment" in a country's history. For these reasons, we think that Iraq affords an excellent opportunity to implement the proposal. And once it is shown to be successful in one or more countries, the demonstration effect will lead people in other countries to lobby for it. ■

Copies of IMF Working Paper No. 03/139, "Addressing the Natural Resource Curse: An Illustration from Nigeria," by Xavier Sala-i-Martin and Arvind Subramanian, are available for \$15.00 each from IMF Publication Services. Please see page 79 for ordering details. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).