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**USING NATURAL RESOURCES FOR AFRICAN  
DEVELOPMENT: FINANCING CASH TRANSFERS FROM  
MINERAL RESOURCE REVENUES**

Master Thesis

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Olomouc, 2012

I declare in lieu of oath that I wrote this thesis myself. All information derived from the work of others has been acknowledged in the text and a list of references is given.

Olomouc, 26.7. 2012

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Signature

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## **List of Abbreviations**

<b>CCT</b>	Conditional cash transfers
<b>EITI</b>	Extractive Industry Transparency Initiative
<b>GDP</b>	Gross domestic product
<b>GNI</b>	Gross national income
<b>GNP</b>	Gross national product
<b>IMF</b>	International Monetary Fund
<b>LDCs</b>	Least Developed Countries
<b>NGOs</b>	Non-governmental organisations
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>PETS</b>	Public Expenditure Tracking Survey
<b>PFD</b>	Permanent Fund Dividend
<b>SWFs</b>	Sovereign wealth funds
<b>UN</b>	United Nations
<b>UNDP</b>	United Nations Development Programme

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## **Abstract**

Natural resources, as is generally believed, represent a significant potential for developing countries in terms of income. Observations in the last decades however suggest that countries endowed with natural resources have struggled to translate this endowment into successful development outcomes. This has been especially true for the countries of Sub-Saharan Africa where the natural resource curse has negatively affected significant number of countries. The very cause of the curse seems to lie in political economy namely in the corrosion of the quality of governance and political institutions.

The policy of direct distribution of resource rents in the form of cash transfers provides option to alleviate the resource curse and to contribute to poverty reduction in countries of Sub-Saharan Africa. This paper examines the causes and consequences of the natural resource curse and considers implementation of resource financed cash transfers in countries of Sub-Saharan Africa. It proposes possible schemes, analyses potential impacts and problems and assesses political feasibility in countries of Sub-Saharan Africa.

**Keywords:** natural resource curse, direct distribution, cash transfers, Sub-Saharan Africa

## **Abstrakt**

Nerostné zdroje bývají často považovány za velký potenciál pro rozvojové země. Zkušenosti z posledních let však naznačují, že právě rozvojové země, které vlastní významné zdroje nerostných surovin, nedokážou tento potenciál zužítkovat pro socioekonomický rozvoj. To je patrné zejména v subsaharské Africe, kde prokletí přírodních zdrojů negativně ovlivňuje mnoho států. Prvotní příčina tohoto prokletí se zdá být především v nízké kvalitě vládnutí a institucí, kterou příjmy z nerostných zdrojů negativně ovlivňují.

Politika přímých transferů financovaných z příjmů z nerostných zdrojů představuje potenciál pro zmírnění prokletí přírodních zdrojů a redukci chudoby v státech subsaharské Afriky. Tato práce zkoumá příčiny a následky prokletí přírodních zdrojů a rozebírá návrh implementace politiky přímých transferů financovaných z přírodních zdrojů. Navrhuje možné modely politiky, analyzuje potenciální dopady a problémy a zkoumá realizovatelnost v zemích subsaharské Afriky.

**Klíčová slova:** prokletí přírodních zdrojů, přímé transfery, přímá distribuce, subsaharská Afrika.

# 1. Introduction

One of the surprising observations in economic development in recent decades is that countries rich in natural resource have performed significantly worse than their resource poor counterparts. This finding appears to be especially valid for Sub-Saharan Africa where resource abundant countries have been plagued with conflicts, poverty, high inequality, indebtedness, bad economic performance and corruption. Despite assistance and policy recommendations provided by external actors African countries have not managed to escape the so called natural resource curse. At the same time several low income African countries have joined the ranks of oil producers in recent years as new discoveries of significant reserves of natural resources have been found in Africa. These countries equally face the risk of being cursed by the inflow of natural resource revenues.

To counter the negative consequences associated with natural resource dependence direct distribution of resource rents in the form of cash transfers among citizens has been proposed. As radical as it may seem the policy has a potential to address the very basis of the natural resource curse that seems to lie in political economy rather than in economy as such by increasing citizens' stake in natural resource management. Moreover distributing the resource rents among citizens may lead to significant positive socio-economic effects as well, including poverty reduction and more equitable income distribution.

The aim of the thesis is to analyse economic and political causes and consequences of the natural resource curse. Further emphasis will be put on different policies for using revenues from mineral resources that have been recommended and used so far in countries of Sub-Saharan Africa. The main ambition is to analyse proposals of using natural resource revenues for financing universal cash transfers, consider different implementation options from the proposed schemes and propose a model that would be feasible and at the same time have the most significant impacts. Further its potential to alleviate the resource curse and contribute to socio/economic development of the countries concerned will be examined and implementation schemes proposed. Potential problems associated with its implementation will be considered as well. Finally the thesis aids to consider potential candidates for the implementation of the policy.

The thesis will be subdivided into three parts. In the first part the relationship between the abundance of natural resources and development will be explored. The idea of the natural resource curse will be analysed with emphasis on the experience of countries in Sub-Saharan Africa. Moreover some of the mainstream proposals for the alleviation of the natural resource curse as well as potential reasons of their limited success will be discussed. This section will provide some theoretical basis for further analysis. Second part of the thesis analyses existing proposals of direct distribution of resource rents to citizens through provision of cash transfers. Rationale for and the origins of the idea will be discussed. Further potential implementation schemes and variations will be analysed, discussed in detail and final model of the policy proposed. The final part of the thesis will reveal potential political as well as economic and social impact of the policy. Most common objections related to the policy implementation will be discussed. The final section of the thesis will cover the most important factors of political feasibility of the policy in resource rich countries. Two country case considerations will be added.

The thesis was elaborated in two stages. In the first stage information were collected from different sources. Articles in electronic scientific journals, scientific books, working papers and articles issued by research organisations such as the Center for Global Development and the Oxford Poverty & Human Development Initiative were the main sources of information. Moreover working papers, web pages and publications issued by international organisations such as the World Bank, the International Monetary Fund, The Organisation for Economic Co-operation and Development and the United Nations, were the main source of information. All sources are cited using the Harvard system of referencing and list of references is provided. The second stage included analytical interpretation of selected data, with author's own conclusions. The author's own contribution is especially in the proposal of the scheme for the resource financed cash transfers which combining the existing models on one hand and other relevant research and experience on the other.

The analysis provided in the thesis is related to the region of Sub-Saharan Africa. Throughout the thesis the term Sub-Saharan Africa and Africa are used interchangeably used both referring to the region in Africa south of Sahara. At the same time the term "resource financed cash transfers" which is the main issue

of the thesis is interchangeably used with terms “direct distribution” or “direct distribution of resource rents in the form of cash transfers” all referring to the same policy. Likewise, the term “natural resources” widely used in the thesis is interchangeably used with terms “mineral resources” and “resources” all referring to mineral resources plus oil. Terms “resource dependent countries” “resource abundant countries” and resource rich countries” are often used in the thesis as well. All of the terms are used interchangeably and refer to countries in which one or very few natural resources dominate in their export structure.

## **2. Natural resources in developing countries**

Primary commodities have traditionally dominated developing countries' exports. In 1970 primary sector products accounted for more than 80% of all their exports at that time (Ross, 1999). Although by the beginning of the 1990's the share had decreased to less than 35% largely due to the rise in manufacturing exports in Asia, in Sub-Saharan Africa primary commodities remained the most important source of foreign exchange in vast majority of countries (ibid). Throughout the first decade of the 21<sup>st</sup> century the share even increased accounting for more than 80% of all regional exports (UNDP, 2011). The dependence is even more severe in the Least Developed Countries (LDCs) situated in Africa which get 90% of all export earnings from primary commodities (ibid.). Africa thus remains a region with the highest dependence on primary commodities worldwide.

The composition of the primary commodity exports varies then from country to country. Besides such natural resources as timber, non-timber forest products and agricultural products, mineral resources constitute a significant part of these primary commodities and, sometimes, most considerable source of income. This is indeed the case of Sub-Saharan Africa where several countries have come to depend heavily on the revenues from mineral resource extraction. Many of them often rely on single commodity such as oil in Nigeria, Chad and Congo for example where it accounts for more than 80% of all exports. The most extreme example among oil exporters is Angola where oil and oil products compose more than 96% of all exports (World Bank, 2011). Nevertheless oil is not the only mineral commodity that African countries rely on. For example, Botswana main export article is diamonds, Zambia gets much of its foreign exchange through the sale of copper and economy of Niger is based on exports of uranium (ibid.).

The aforementioned dependence on resource exports creates an impression that they are extraordinary rich in mineral resource. However, as Collier (2010) or Lin (2008) illustrate, when current reserves of so called subsoil assets<sup>1</sup> in the poorest developing countries is compared to the stock of reserves in OECD countries such impression disappears. While in the group of OECD countries the average estimated reserves of subsoil assets per square kilometre is 114,000 US dollars, the value

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<sup>1</sup> Subsoil assets as defined by the United Nations are all mineral resources on or below the earth's surface (OECD, 2001).

of mineral resources in so called Bottom Billion<sup>2</sup> countries is only 29,000 US dollars per the same area. In Sub-Saharan Africa alone the estimated value is merely 23,000 US dollars (Collier, 2010). Since it is improbable that higher amount of mineral resources would be determined by the countries' level of economic development, Collier (2010) attributes the difference to the lack of prospecting. Hence we could, according to Collier expect new deposits of mineral resources to be discovered in developing countries in the future. The notion has also been confirmed by recent discoveries of oil in a number of developing countries several of them being from Sub-Saharan Africa<sup>3</sup> (Moss, 2011; Sandbu, 2006; BBC, 2011; BBC, 2012).

Such hypothesis suggests optimistic outlook for the poorest developing countries in terms of future revenues from these resources. And since Africa's current revenues from natural resources surpass even today any other foreign financial flows including aid, mineral resources, if harnessed properly and used effectively, represent a great opportunity for development of the poorest developing countries (Collier, 2010). Paradoxically, despite its enormous potential, income from natural and, especially mineral resources, has hardly led to successful economic development of resource rich developing countries so far. In fact vast majority of them have been struggling to keep up with their resource poor counterparts. As Mehlum et al. (2006, p.1) put it:

“One important finding in development economics is that natural resource abundant economies tend to grow slower than economies without substantial resources. For instance, growth losers, such as Nigeria, Zambia, Sierra Leone, Angola, Saudi Arabia and Venezuela, are all resource-rich, while the Asian tigers: Korea, Taiwan, Hong Kong and Singapore, are all resource-poor. On average resource abundant countries lag behind countries with less [sic] resources. “

Although this assertion is indeed simplified, findings of other scholars (for example Sachs and Warner, 1995; Auty, 1993; Collier, 2007) have confirmed the inverse relationship between natural resource abundance and economic performance. At the same time however, majority of scholars including Mehlum et al. (2006) and

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<sup>2</sup> Group of 58 poorest developing countries as defined by Collier (2007).

<sup>3</sup> Sierra Leone and Liberia will become new oil producers in Western Africa while new discoveries of significant oil reserves have been found in Uganda and Kenya (Moss, 2011; BBC, 2012). Moreover, large gas field has been discovered in Mozambique (BBC, 2011) and Significant iron ore deposits are about to be exploited in Sierra Leone (Nair, 2012).

others (Stevens, 2003; Davis and Tilton, 2005; Larsen, 2006) state that such negative association is not always necessary and there are exceptions to this rule. Understanding mechanisms of this phenomenon is therefore crucial to help existing and future resource exporters manage windfalls in an economically sound way.

## **2.1 Paradox of Plenty – the case of the natural resource curse**

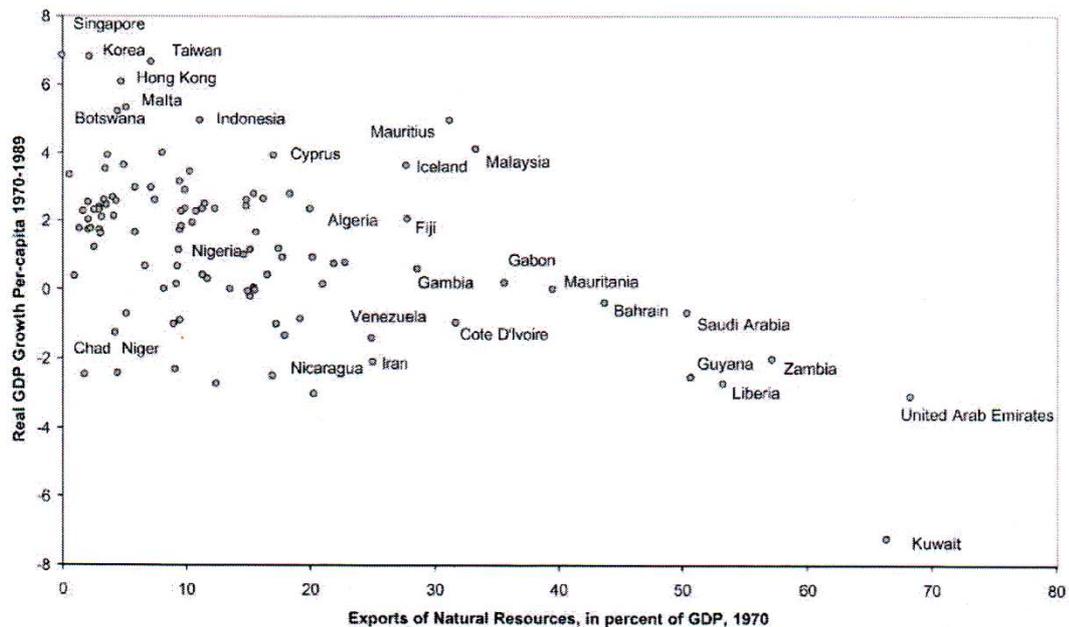
In conventional neo-classical economic thinking, natural resources are viewed as a part of country's natural capital that once extracted and converted to other forms of capital can be used to fuel development of other sectors and, eventually, economic development as such especially in early stages of development (Davis and Tilton, 2005; Auty, 1993). Historically, as has often been argued, this was the case of Great Britain, Germany and the United States. Thanks to rich coal and iron ore deposits these countries managed to develop extensive steel industry in the 19<sup>th</sup> century (Sachs and Warner, 1995). Physical availability of resources was a great advantage for these countries notably because of high transport costs at that time. As the transport costs rapidly decreased in the course of 20<sup>th</sup> century, physical proximity of resources was no longer important. This explains why such countries as Japan or South Korea, which are resource poor, have become important steel producers (ibid).

At the same time, as mentioned earlier, it has been observed that resource abundance especially in developing countries has caused and is still causing more harm than good (Davis and Tilton, 2005). The fact that many of the ; countries fail to harness the potential of natural resources and transform the associated income to successful development has been referred to as the curse of natural resources (for example, Sachs and Warner, 2001; Mehlum et al, 2006; Collier, 2007; Davis and Tilton, 2005). Alternatively, the phenomenon is also known as the Paradox of Plenty, which is a term first coined by Auty (1993).

Although some scholars (for example Van der Ploeg and Poelhekke, 2010; Brunnschweiler and Bulte, 2008) question the resource curse hypothesis, the majority of authors agree that the detrimental effects of natural resources exist. As Sachs and Warner (2001, p.828) claim:

“What the studies based on the post-war experience have argued is that course of natural resources is a demonstrable empirical fact [...]. Empirical support [...] is not bulletproof, but it is quite strong.”

In one of their influential works Sachs and Warner (1995) present a cross country regression where they analyse data from 95 developing countries worldwide between 1970 and 1990. They show that countries that were rich in natural resources<sup>4</sup> at the beginning of the period, experienced on average slower growth than resource poor countries even after controlling for other variables such as previous growth rates, geography and climate. The negative association is illustrated in figure 1<sup>5</sup>.



**Figure 1:** Relationship between exports of natural resources and economic growth (Sachs and Warner, 2001)

<sup>4</sup> Natural resource based exports include agriculture, minerals and fuels since according to Sachs and Warner (2001) excluding agriculture does not make any difference. This notion is supported also in Gylfason (2001a) arguing that the findings are valid for all types of natural resources.

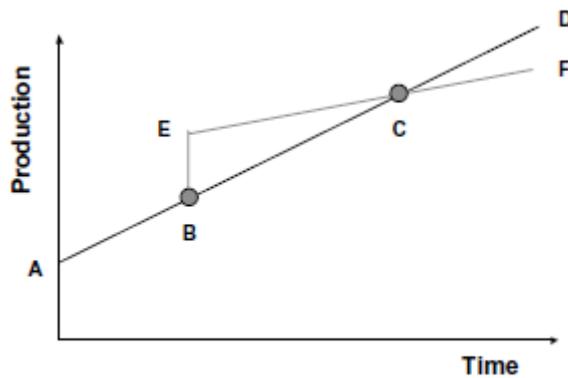
<sup>5</sup> The only exceptions in this calculation were Malaysia, Mauritius and Iceland (Sachs and Warner, 2001).

In a similar manner Gylfason (2001a) compared economic performance of 85 countries between 1970 and 1993 and found out that economic performance in terms of per capita GDP growth was well below the average in countries rich in natural resources especially those from Sub-Saharan Africa. In small mineral (non oil) rich countries long term economic growth was even negative (ibid.). To be more specific Auty (1993) calculated that the negative effects of resource rents<sup>6</sup> manifest in those mineral economies where natural resources account for more than 8% of GDP or 40% of all exports. In addition Gylfason (2001b) calculated that increase in natural capital share in total capital by 10 percentage points is associated with a decrease in growth by one percentage point per annum on average. The decline in the output of resource rich economies can usually be observed in the long run while shortly after the discovery, as illustrated in figure 2 (p.18), the output usually rises (Gylfason, 2001a; Collier 2010).

Decline in economic growth is not the only negative effect that resource dependent countries encounter. Due to its negative impact on growth, resource dependent developing countries also experience higher poverty rates (Collier, 2007). In Nigeria, one of the countries that depend on oil, problems related to natural resources are believed to have largely contributed to the increase in the number of people below the poverty line from 19 million in 1970 to 90 million in 2000 (Birdsal and Subramanian, 2004). Besides, it has been argued by Collier and Hoeffler (2005) that resource dependence is associated with higher risk and incidence of civil conflicts and Gylfason (2001a) points to higher income inequality, debt and corruption in these countries.

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<sup>6</sup> Excess (unearned) income associated with natural resource revenues (i.e. anything above returns on investments and risks taken) (Collier, 2010).



**Figure 2:** Relationship between natural wealth and growth (Gylfason, 2001a)

**Note:** Trajectory ABCD reflects a steady economic growth. Trajectory ABECF on the other hand illustrates discovery of natural resources (point B) increases the economic growth in short run, while in the long run it makes the economy worse off (starting from point C) compared to the situation without the discovery of natural resources.

Indeed, the curse of natural resources is not unique to the countries of Sub-Saharan Africa and findings are equally valid for many other resource dependent countries from all over the world. Nevertheless there *is* something specific about African countries, namely the share of mineral resources in their economies, which is second largest after Middle East oil exporting countries and accounts for 30% of GDP (Collier, 2010). Moreover the concentration of resource dependent countries facing serious problems of poverty and conflicts is higher in Africa than in any other developing region (Ross, 2001; World Bank, 2011, Collier, 2007). Historical as well as present examples of conflicts and economic problems in resource dependent countries such as Sudan, Angola, Congo, Nigeria, Sierra Leone, Zambia and so forth are well known (Collier, 2007; Sayed, 2007; Moss and Young, 2009; Mehlum et al., 2006).

However, there are some exceptions to the rule most of which can be found outside Africa. Malaysia, Indonesia and Thailand, all of them natural resource rich countries, managed to maintain average GNP per capita growth of 4% between 1970 and 1998 (Gylfason 2001b). Botswana serves as another positive and fairly unique example. Not only it has managed to maintain high growth rates in the last decades<sup>7</sup>

<sup>7</sup> Average economic growth of Botswana (measured in GNP per capita) of Botswana between 1967 and 2010 was 9.3 % per annum (World Bank, 2012a).

but also holds the lead in Corruption Perception Index among African countries (Transparency International, 2010). To top it all Botswana is the only African country to leave the group of the LDCs. These examples indicate that resource curse is not inevitable. Indeed these, and some other<sup>8</sup>, positive examples have been observed and acknowledged by many if not all authors dealing with the resource curse (for example Collier, 2010; Larsen, 2006; Mehlum et al., 2006). What exactly lies behind the success stories has been extensively debated and will be covered in following sections. The fact remains that natural resources represent not only a threat but also enormous potential that is usually not exploited. As Collier (2010) notes, despite threefold increase in prices of oil between 1996 and 2006 and associated GDP growth in oil exporting African countries, long term effect of this oil boom on growth will be negative if history is to be repeated. Yet those revenues are far greater than other external transfers to the country including foreign aid. For illustration in 2008 Angola's oil revenues were more than twice higher than all the aid transferred to what Paul Collier refers to as countries of the Bottom Billion (ibid).

Finding out how to utilise the potential of natural resources for economic, and eventually social development will be therefore crucial not only for current resource exporters but especially, as has already been mentioned, for those countries that have recently become or will become mineral producers in the foreseeable future. Prior to suggesting possible solutions however, causes of the problem have to be examined.

### **2.1.1 Mechanisms of the natural resource curse**

Although the negative effects of natural and especially mineral resource dependence on economic performance have been known for a while<sup>9</sup> the debate about what exactly behind this relationship is failed to deliver straightforward and clear results. Nevertheless most of the authors generally agree on the fact that natural resources crowd out activities that are vital for growth. Although it has been disputed what

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<sup>8</sup> For example Chile, Norway are frequently considered as other success stories among resource rich countries

<sup>9</sup> Such observation can be traced back to 14<sup>th</sup> century Arab philosopher Ibn Khaldun, French philosopher Jean Bodin, Economist Adam Smith or, more recently Raul Prebisch and Hans Singer (Stevens, 2003)

exactly those activities are, disputed, the most frequent explanations found in the literature can be divided into 2 categories – economic and political<sup>10</sup>.

Most of the economic explanations of natural resource curse evolve around a well known phenomenon called the Dutch Disease<sup>11</sup>. The term was created to name the negative effects of the North Sea gas revenues on Dutch economy in 1970's after the discovery of the Groningen gas field (Stevens, 2003). It stands for contraction or disappearance of the non resource traded goods sector - predominantly manufacturing (Gylfason, 2001; Larsen, 2006). Since manufacturing is believed to be one of main drivers of economic growth, its absence leads to negative consequences. This anomaly works through different mechanisms. The first is associated with factor movement effect as the resource sector takes scarce labour and capital away from manufacturing and/or agriculture to the mineral sector and non-tradable sector<sup>12</sup> and as consequence the price of the production factors rises. This makes other traded goods sectors uncompetitive (Larsen, 2006). Second mechanism is linked to spillover loss effect, which means that resource sector produces little domestic backward and forward linkages (ibid.). Few local businesses are established to supply inputs or to process the primary commodities (Auty, 1993; Ross, 1999). Subsequently, positive externalities associated with manufacturing sector such as learning by doing or innovations are lost. Third, export of natural resources brings rents that are detrimental for resource economies. By converting such revenues into domestic currency the aggregate domestic demand increases. This leads to appreciation of domestic currency (Larsen, 2006). All of the aforementioned mechanisms negatively affect competitiveness of manufacturing sector.

Besides Dutch Disease decline in terms of trade for primary products and hence mineral commodities as well, has been another suggested cause of the natural resource curse. These suggestions are based on the ideas of Raul Prebisch and Hans Singer (Prebisch, 1950, 1964; Singer 1950 cited in Stevens, 2003, p. 5, 6) who

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<sup>10</sup> These categories are instrumental only. The division is not strict and some of the explanation may fit both into economic and political at the same time.

<sup>11</sup> The term has been used in two senses in the literature. The term in its broader sense has been used to describe all negative effects of the resource sector on economy. For the purposes of this thesis the term is used in its narrower sense depicting negative effects of high resource rents on non resource traded goods sector.

<sup>12</sup> For example services, construction and retail trade.

argued that in the long run, primary exporting countries would become disadvantaged because of deteriorating terms of trade for primary commodities. However this idea has been widely contested. Ross (1999) for example argues that the terms of trade have changed significantly only for few commodities and this decline would not affect developing countries so much. Even though Stevens (2003) confirms that terms of trade worsened at some points, he argues at the same time that slight decline in terms of trade cannot explain bad performance of mineral economies.

Another and according to Stevens (2003) more serious concern associated with changing prices is volatility of income which is commonly the case in mineral economies. Since the prices in commodity markets are not stable, resource dependent economies face higher income fluctuations (Ross, 1999). Indeed as Stevens (2003) notes, mineral economies experienced two to three times higher revenue volatility between 1972 and 1992 compared to the non-mineral economies. In such situations it becomes difficult for governments to maintain prudent fiscal policy (*ibid.*). In such unpredictable environment planning is especially difficult. In times of high prices, government can afford higher spending. When the price of commodities decreases the spending is usually not adjusted resulting in high fiscal and current account deficits (Collier, 2007). As Collier (2007, p. 40) further notes, “volatile revenues are obviously difficult to manage. During a price boom, government ministries, scenting the money available, put in outrageous bids for more spending”.

The case of revenue volatility and inability of governments to manage prudent fiscal policies suggest that causes of natural resource curse is, besides economy, associated with politics and governance as well. Indeed, number of authors maintain, that natural resource curse is a matter of political economy (for example Sayed 2007; Larsen, 2006; Sandbu, 2006; Devarajan et al., 2011; Segal, 2011 and others). When resource rents become abundant, for example during commodity booms, governments may be prone to myopic behaviour (Ross, 1999). The feeling of relative prosperity and false security not only makes it difficult for governments to maintain prudent fiscal policy but easy unearned income may also trigger unproductive investments and military spending (Collier, 2007; Stevens, 2003; Moss and Young, 2009; Gylfason, 2001a). As Collier (2010) argues the problem of the poorest resource rich countries is not that they do not invest, but that

they invest wrongly and with low returns<sup>13</sup>. Moreover Sayed (2007) and Sachs and Warner (2001) argue that investments in human capital and entrepreneurship suffer in countries rich in natural resources. The reason for this is lack of motivation and incentives for governments and public to invest in education because of high natural resource rents and high wages in the sector respectively (Gylfason, 2001b). And truly, school enrolment is worse in resource rich countries (ibid.).

Besides, resource rents are usually associated with rent seeking behaviour which is especially detrimental for development. Where rent seeking is present, money is diverted away from developmental goals to maximizing personal profit (Stevens, 2003). Those engaged in rent seeking are interested in maintaining status quo and thus prevent any reforms from being adopted (ibid.). Economic development therefore suffers despite large revenues from the sale of natural resources. In addition, rents often feed corruption and empower interest groups that advocate inefficient policies or privileges for certain groups (Ross, 1999).

Another problem and as will be argued later, for the purposes of this thesis probably the most important one is, that large revenues from natural resources free governments from the need to tax (Ross, 1999; Devarajan et al, 2011). In such environment it is more cost effective for politicians to bribe voters by public money instead of delivering public services (Collier, 2007). The problem is that without taxation politicians do not feel accountable to citizens and citizens are not motivated to monitor the spending of the public resources. Further, Collier (2007) finds out that resource rents are damaging for democracy and resource rich countries are more likely to experience autocratic regimes.

Although the political and economic aspects of the resource curse are divided here, as has been argued earlier both are confined to bad governance. In other words negative effects of resource rents are not found in countries with good governance and strong institutions. By the same token Larsen (2006, p.610) argues:

“Neither the curse [of natural resources] nor the [Dutch] disease is thought of as an inevitable outcome. Both seem attributed to some unwelcome arrangement of institutions or inappropriate policies”

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<sup>13</sup> Collier (2010) mentions White elephant project as an example of wasted investments. An example may be Nigerian Ajakouta steel complex which has not produced any steel in four decades (Birdsall and Subramanian, 2004).

This is to suggest that resource curse is not unavoidable and if appropriate measures are implemented countries can benefit from natural resources as it happened for example in the case of Norway, Botswana or Chile (Collier, 2010; Gelb and Grasmann, 2010).

### **2.1.2 Avoiding the curse**

The curse of natural resources is a very complex issue that has proven to be very difficult to tackle especially in developing countries. Suggesting optimal set of measures to combat the curse and to utilise natural resources for productive and developmental purposes is therefore a tricky task. Nonetheless several policy suggestions for handling excess revenues from natural resources can be found across literature. They usually refer to as success stories such as Norway, Botswana, Malaysia, Chile, and other where these policies are found and are believed to have helped them harness the potential of natural resources (for example Birdsall and Subramanian, 2004; Sarraf and Jiwanji, 2001; Iimi, 2008; Gelb and Grassmann, 2010).

Botswana, the 18<sup>th</sup> largest per capita resource exporter in the world, is a textbook example of how mineral resources in contrast with other African resource rich countries can be utilized to fuel economic growth (Iimi, 2008). Being one of the 25 poorest countries in the world at independence, the discovery of the first diamond mine in 1967 ushered in a successful development path, unprecedented in history with average annual GDP growth of 9.3 % between 1967 and 2010 (Sarraf and Jiwanji, 2001; World Bank, 2012a). The success of Botswana can be observed not only in terms of economic growth also in other indicators such as infant mortality rate as illustrated in table 1 (p.24). Until the 1990's outbreak of HIV/AIDS epidemics Botswana fared much better in terms of life expectancy as well (Sarraf and Jiwanji, 2001).

	Botswana				Sub-Saharan Africa			
	1965	1989	1998	2010	1965	1989	1998	2010
<b>GNP per capita (constant 2000 USD)</b>	283.8	2254.2	2985.9	4189.4	458.7	542.0	510.6	644.0
<b>Life expectancy at birth (years)</b>	52.3	64.1	53.8	53.1	42.5	49.6	49.4	54.2
<b>Mortality rate, infant (per 1000 live births)</b>	102.8	44.9	63.4	36.1	146.8	105.8	97.6	76.4

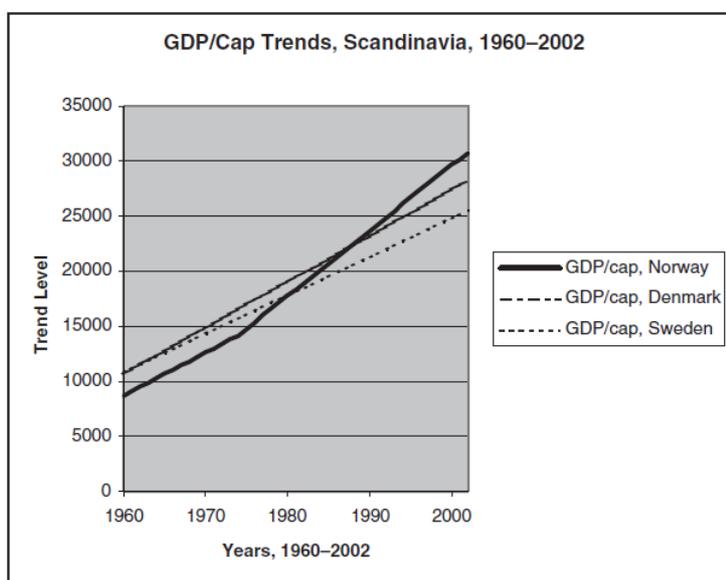
**Table 1:** Comparison between Botswana and Sub-Saharan Africa (all income levels) for selected indicators (Sarraf and Jiwajji, 2001, data modified according to World Bank, 2012a)

Botswana has managed to avoid the well known resource related problems by adopting several sound measures. First, the government of Botswana has accumulated considerable international reserves in a natural resource fund despite political pressures to spend more of the windfall revenues (Stevens and Dietsche, 2008; Sarraf and Jiwajji 2001). This reduced inflationary pressures and allowed government to smooth the revenue flow over time and balance budget deficits in times of crisis (Weinthal and Luong, 2006). Second, the government maintained prudent spending policy based on long term income expectations rather than commodity booms. Botswana thus avoided the need for drastic cuts and borrowing in times of economic crisis<sup>14</sup> (Sarraf and Jiwajji, 2001). The prudent fiscal policy was secured through so called National Development Plans regularly approved by the government (Stevens and Dietsche, 2008). Third, the government of Botswana has managed to maintain sound exchange rate policy avoiding excess appreciation of exchange rate. This was partially realised through the aforementioned accumulation of foreign reserves and helped to maintain the competitiveness of other non-resource traded goods sectors (Sarraf and Jiwajji, 2001, Weinthal and Luong, 2006). Finally, good resource management has been vindicated by high investment to education, health and infrastructure (Moss and Young, 2009). Nevertheless there is still some room for improvements. As Stevens and Dietsche (2008) argue Botswana

<sup>14</sup> Unrestrained spending during the of commodity boom in 1970s in other resource rich developing countries such as Nigeria and Mexico led to debt crisis and balance of payments problems. Prudent spending policies helped Botswana withstand the decline in revenues during the crises in 1981/1982 and more recently in 2009 (Sarraf and Jiwajji, 2001; World Bank, 2012a).

government has not been able to fully prevent unproductive public investments and Iimi (2006) points to the fact that economic growth in this country may not be sustainable since the diversification efforts have not been very successful. The country failed to diversify its exports through agriculture especially due to the severe and frequent droughts. On the other hand its manufacturing sector fared much better than in the rest of Sub-Saharan Africa (Sarraff and Jiwanji, 2001).

Another good example of natural resource management can be found in Norway. While it used to be one of the poorest countries in Europe in 1900 it is now one of the world's most developed countries occupying the first rank in United Nations Human Development Index classification (Mehlum et al., 2006; UNDP, 2011). In 1960s and at the beginning of 1970 Norway was in the shadow of its richer but resource scarce Scandinavian neighbours Sweden and Denmark in terms of overall economic performance. Nevertheless some years after the discovery of oil in 1969 and the beginning of extraction, things have begun to change. During the next 25 years after 1975, Norway experienced faster growth than its neighbours and managed to overcome them (figure 3) (Polterovich et al., 2010, Larsen, 2006).



**Figure 3:** Trends in GDP per capita in Norway, Denmark and Sweden, 1960-2002, 1999 USD PPP (Larsen, 2006)

After 1990 the Norwegian government set up a State Petroleum Fund which accumulates windfall oil revenues invests them in foreign securities and protects domestic economy from overheating (Gylfason, 2001b). Norway has also wisely invested in oil sector research accumulating important know how domestically with positive spillovers to other sectors. Besides, government also favoured general investments in education, research and development in general what is regarded as an important step towards maintaining competitiveness of other sectors (Larsen, 2006).

Chile, Malaysia and Indonesia are other examples commonly referred to as success stories. Indonesia, possessing significant reserves of oil experienced periods of instability and chaos until Suharto came to power. In cooperation with a team of economic advisors known as “Berkeley Mafia”<sup>15</sup> he implemented several macroeconomic reforms such devaluing the exchange rate three times and adjusting spending according to actual oil prices (Gelb and Grasmann, 2010). In addition Indonesia took the opportunity to diversify its export base through supporting agriculture and other non resource traded good sectors (ibid.).

The case of Chile offers, according to Gelb and Grasmann (2010), another remarkable success story. The country faced severe inflation up to 3000%, serious debt crisis and unemployment rocketing to 33% after politically turbulent period in 1970’s and 1980’s. This resulted in high demand for sound economic policies and subsequently in several measures taken by the government throughout the following decades. The result was significant reduction of public debt which reached minus 14% of GDP in 2008, and accumulation of windfall revenues in a stabilisation fund to smooth copper revenues. Besides macroeconomic policies, the Chilean government took other important steps such as provision of infrastructure, disseminating information and supporting small scale producers to encourage growth in other high value industries (ibid.).

Indeed, all of the aforementioned successful countries cannot be regarded as a homogenous group. They differ in various aspects including level of development, geography, type of mineral endowment and the like. Nonetheless, all of them implemented several measures that are generally regarded as necessary or, at least, vital for economic development in resource rich developing countries. The resource

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<sup>15</sup> The term Berkeley Mafia is derived from Berkeley University in the United States which was one of the US universities where these economists studied (Djurfeldt, 2005).

dependent African countries are equally heterogeneous and cannot be regarded as single group. Nevertheless many of the measures are often contained in policy recommendations for these, not very successful resource rich countries.

### **2.1.3 Policies versus politics: What really matters?**

Policy suggestions that can be found in the literature vary from rather ambiguous to more specific in one respect and from unrealistic to relatively feasible in another. Most of the time the policy suggestions come in a bundle and are a blend of economic as well as political measures.

One of the specific yet probably unrealistic advices obviously not applied in any of the above success stories is presented by Ross (2001). He considers leaving resources in the ground to avoid the negative effects of extractive industries that have been analysed in the previous chapters. Although this solution is pretty straightforward Ross (2001) at the same time realises that it is not politically feasible. Moreover it would perhaps not be economically sound especially in the case of Sub-Saharan Africa. As Collier (2010) argues, natural resources represent valuable source of potential income for African countries that are usually short of capital. By the same token postponing the extraction may not be fortunate choice since the rate of return on domestic investment is especially high in these countries and prices of any natural resource may be less favourable in the future than they are now. To sum it up leaving resources in the ground would not be politically viable on one hand and, on the other, extracting resources and investing revenues domestically will in theory bring higher returns than leaving them in the ground for the future (*ibid.*). This consideration is of course valid in case resources are invested productively and this is exactly what other proposals deal with.

Other suggestions are often based on historical experiences inspired by the aforementioned as well as other success stories. One of the common policy recommendations is the adoption of sound macroeconomic and fiscal policies (for example Sarraf and Jiwanji, 2001; Weinthal and Luong, 2006; Stevens, 2003). Directing windfall revenues to so called sovereign wealth funds (SWFs) is one of

the most common practices in resource rich countries<sup>16</sup>. Botswana Pula Fund, Norwegian Government Pension Fund (formerly known as Petroleum Fund) and Chilean copper fund are examples of how SWFs can be wisely used (Gelb and Grasmann, 2010; Larsen, 2006). SWFs may serve for different purposes. First, they accumulate foreign assets and thus protect the domestic currency from appreciating (Weinthal and Luong, 2006). Second, the accumulation of foreign reserves reduces inflationary pressures and third, SWFs help smooth revenue volatility that is common in resource exporting countries (Sarraf and Jiwaji, 2001; Collier, 2010). Fiscal discipline has been another common feature of so called “good performers”<sup>17</sup>. Adjustment of spending according to current resource prices and revenues has led not only to low current account deficits but actually to current account surpluses in all of the abovementioned success cases (Gelb and Grasmann, 2010).

Considering all the facts that have been said about the mechanisms of the Dutch disease, there is little wonder that another very frequent suggestions that can be found in the literature along with prudent macroeconomic and fiscal policies is to support economic diversification (for example Weinthal and Luong, 2006; Ross, 2001). As obvious as this suggestion may seem it is in fact very difficult to achieve (Stevens, 2003). Its importance however is stressed by the fact that in all of the above, as well as other success stories economic diversification played an important role in economic development (Gelb and Grasmann, 2010). Nevertheless, economic diversification goes hand in hand with other economic policies, especially exchange rate policy (i.e. avoiding excessive appreciation which would disadvantage other tradeables) and investment strategies which ought to direct the resource rents towards the non-resource traded goods sectors as well as encourage private investments (ibid.). Indeed, and again investments mostly in infrastructure, temporary subsidies, education and so on has been present in all of the examples discussed above.

The policy recommendations introduced all appear to be merely technical issues and seem to be easily applicable in any other country. Indeed, these policies

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<sup>16</sup> SWFs may take different forms. While future generations funds (as for example the Norwegian Government Pension Fund) aim to save the revenues, as the name indicates, for future generations, while stabilisation funds serve mainly for smoothing the revenue flows (Moss, 2011). Both types of funds, if managed well contribute to desirable outcomes.

<sup>17</sup> The term „good performers“ refers to the success stories in general and, to the successful examples analysed in the previous chapter in this case i.e. Botswana, Chile, Norway and Indonesia (used by Gelb and Grasmann, 2010).

were implemented in many other resource rich countries. The success however has been limited and several failures may be traced in Sub-Saharan Africa.

Considering the natural resource funds for instance, Humpreys and Sandbu (2007) as well as others (Moss, 2011; Pegg, 2005) argue that a fund as such does not guarantee good management of natural resources. They can be found in countries that manage the resource rents well (for example in Norway etc.) as well as in countries that do not. To be more specific Moss (2011) gives an example of a SWF that was, with the best of intentions, implemented in Chad by the World Bank as a condition for providing a loan needed to construct a pipeline<sup>18</sup>. As soon as the bank withdrew and the loan was repaid Chadian legislators quickly adjusted the rules of treatment and spend part of the resources from the fund for military and other convenient purposes (ibid.). Another infamous example of SWF presented by Moss (2011) can be found in Nigeria where the government rarely follows the rules of saving and spending. These examples imply that SWF alone is not means to an end. Besides unsuccessful attempts to set up and manage saving fund many of the resource rich developing countries have sought to diversify their production and, ultimately, their export portfolio. Historically, the efforts have usually not been brought to a successful conclusion most notably in African resource exporters. The failure of African countries to diversify is well illustrated by the share of resources in exports presented in previous chapters (World Bank, 2011). Weinthal and Luong (2006, p. 39) clarify some of the possible causes:

“Efforts to mitigate the effects of Dutch Disease by transferring rents from the mineral sector to the non-booming export sectors, however, have actually had a decisively adverse economic effect. State-led investment in that historical context has led not only to inefficient investment but also to the perpetuation of import substitution industrialization and protectionism — both of which have independently contributed to stagnant growth rates.”

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<sup>18</sup> The so called Chad–Cameroon Petroleum Development and Pipeline Project has been the largest single private sector investment in Africa. The project aimed to develop oil fields in southern Chad, export them via new pipeline through Cameroon and at the same time help Chad beat the resource curse and utilise the resource revenues for poverty alleviation and other developmental goals (Pegg, 2005; Bannon and Collier, 2003). Although for example Weinthal and Luong (2006) see the project as a success other authors including Pegg (2005) and Moss (2011) argue, that the project has largely been a failure and will lead neither to poverty alleviation nor to the avoidance of the resource curse.

Hence, diversification and investment efforts often go bankrupt due to inefficient investments and protectionist practices, and possibly by some exogenous factors (Gelb and Grasmann, 2010; Ross, 2001)<sup>19</sup>. The aforementioned evidence raises the questions – why in some countries the policies have been successful at least to some extent while in other the efforts have been taken in vain? The answer to the questions arises out of the previous analysis of the resource curse as well as from the evidence from the success stories wittily summarized by Stevens (2003, p. 4):

“[...] essentially it is something to do with *governance* and the answer lies more in political economy than macro-economic analysis. Hence the key question is *not what was done? It is why was it done?*” [emphasis added]

Governance and quality of the institutions not only predetermine whether a country will be cursed by natural resources (analysed by Mehlum et al., 2006; Larsen, 2006; Gylfason, 2001a; Collier, 2010 and others), but also determine whether measures taken will be successful or not (for example Iimi, 2006; Weinthal and Luong, 2006; Stevens and Dietsche, 2008). Therefore, another common “policy” suggestion is to improve governance and institutions although opinions on what institutions are important and what is the best way to improve them differ. Iimi (2006, p.9) sheds some light on the issue by selecting “four aspects of governance [that] seem to be particularly important for natural resource management” most of which were present in Botswana - the African success story. The first variable important for good governance is voice and accountability, in other words the ability of citizens to effectively monitor government. Next, government effectiveness i.e. the quality of public service related to the ability of civil servants to manage resource revenue is important. Another element important for governance to be good is a long term relationship with private parties related to the level of regulation and price control as well as to the extent to which government policies are market friendly. Last but not least low corruption is a crucial, if not most important precondition of good governance (ibid.). As for the resource dependent African countries, apart from Botswana, the reality does not really match the introduced

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<sup>19</sup> Ross (2001) claims that one of the main factors hindering diversification in resource producing developing countries is the escalation of tariffs on processed raw materials imposed by the developed (OECD) countries.

concept of good governance. As documented by Transparency International (2010) corruption is especially problematic in many resource (mainly oil) dependent countries<sup>20</sup>.

Bearing in mind the importance of good governance and capable institutions for harnessing the potential of natural resources, international non-governmental organisations (NGOs) have been pressing on the International Financial Institutions (World Bank and the International Monetary Fund), developed countries as well as private companies engaged in resource extraction to take part in initiatives that aim to promote good governance, transparency, accountability and responsibility in management of resource revenues in resource rich yet poor developing countries (Weinthal and Luong, 2006). One example of such initiative is so called Extractive Industry Transparency Initiatives (EITI). Based on previously launched Publish What You Pay initiative<sup>21</sup>, EITI is a coalition of governments, NGOs, private companies and international institutions, which encourages the member countries to publish all payments, fees and royalties they receive from the extractive sector and on the contrary, companies to publish what they pay to the governments (Ocheje, 2008; Weinthal and Luong, 2006; Maconachie, 2009).

The rationale behind initiatives like EITI and the like is, that by disclosing all available information to the public system of checks and balances will be created which will hold the companies and especially governments more *accountable* (Maconachie, 2009). At the same time, local civil society (namely NGOs) is supposed to play decisive role in promoting the process (Weinthal and Luong, 2006). Besides EITI, World Bank and the International Monetary Fund have, used their leverage and conditioned different form of assistance upon implementing transparency legislation (Bannon and Collier, 2003). In spite of considerable effort of external actors initiatives have been not very successful in Sub-Saharan Africa. While the implementation of EITI initiative has been problematic for example in Sierra Leone (Maconachie, 2009), World Bank and IMF conditionalities have not

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<sup>20</sup> There are six countries in Sub-Saharan Africa identified as highly corrupt - i.e. having scored less than 2 point in the Corruption Perception Index rank (Transparency International, 2011). Four of them - Equatorial Guinea, Angola, Sudan and Chad are all oil dependent countries (World Bank, 2011).

<sup>21</sup> Publish What You Pay is an initiative and a global campaign launched by a network of international NGOs that advocates the disclosure of information about the financial flows from companies operating in extractive industries in developing countries (Bannon and Collier, 2003).

worked at all in Angola (Bannon and Collier, 2003) and have also largely failed in Chad as a part of previously mentioned and not very successful Chad–Cameroon Petroleum Development and Pipeline Project (Bannon and Collier, 2003; Pegg, 2005).

There are various reasons why efforts of external actors to promote transparency and good governance have not succeeded much so far. First, problems arise out of the fact that the initiatives are driven by external and not local actors (Weinthal and Luong, 2006). Although local NGOs are supposed to play the main role in monitoring the spending of oil rents and hence are inherent part of the programs, they do not take part in designing the programs. At the same time they suffer from low capacity (Maconachie, 2009). Even considerable effort is put into capacity building this will be hardly enough to positively change governance and institutional settings after the pressure of external actors has ceased (Stevens and Dietsche, 2008). Second, positive change will be hard to achieve due to the fact that current practices of rent seeking may be deeply rooted in mining sectors of resource dependent developing countries. As Maconachie (2009, p. 77) comments on the case of Sierra Leone:

“[...] not only is the capacity for promoting transparency and accountability low, but relatively weak civil society actors remain largely unable to monitor or challenge the power of well established rent-seeking actors who are firmly established in the mining sector...it is unlikely that the disclosure of payments within the diamond industry will rapidly dissolve these powerful networks.”

Third, Maconachie (2009) argues that initiatives like EITI and the like usually include central and local governments but omit important stakeholders in mining industry for example local authorities that may control significant part of the financial flows from the mining industry. Fourth, governments are often not interested motivated to manage the resource revenues effectively. And because the demand for effective management comes from the outside usually as a condition for financial support governments usually sign whatever they are required to. What happens next has been observed by Pegg (2005, p.21) who offers a valuable experience from Chad:

“[...] while help from international organizations ‘often entails a commitment to political reform, once aid is delivered and the leaders’ political problems are solved, they renege on promises of political reform’. As new oil comes online that is not covered by the revenue management law and the percent of revenues covered by that law declines, Chad’s leaders will increasingly set their own terms for this project.”

Judging from the previous analysis it is evident that despite considerable efforts, policy recommendations and implementations, along with the attempts to promote good governance have been largely unsuccessful and many countries remain seriously affected by the natural resource curse.

#### **2.1.4 Domestic demand – the detail that makes the difference**

Being aware of all the problems especially the lack of good governance that many of the resource rich African as well as some other developing countries face, scholars have been struggling to find out what it is that makes governance and thus the management of resource revenues significantly better in some countries (here referred to as success stories) than in other. Since external pressure (in other words external demand) is, as documented, very unlikely to deliver results in the form of good governance and lower corruption, domestic demand for transparency and good governance on the other hand has proven to be crucial factor for creating favourable climate for sound natural resource management (Devarajan et al. 2011). At the same time the domestic demand for sound resource revenue management is the very aspect that is missing in resource rich yet poorly managed developing countries. In other words it must be the citizens - constituencies - not international organisations that will hold the government accountable for their actions (Stevens and Dietsche, 2008). The importance of constituencies is also emphasised by Rajan and Zingales (2006, p. 40):

“Changing explicit institutions without changing the constituencies backing them is likely to be a futile exercise, for the constituencies against change will find a way around the constraints imposed by the institutions.”

Getting back to the success stories it is apparent that the demand for and tradition of democracy and good governance and institutions played an important role in the process of effective use of natural resources. Norway for instance had been a well functioning democracy for more than 150 years at the time of oil discovery (Moss and Young, 2009). Powerful constituencies, support of and deeply rooted demand for sound spending and saving policies have played decisive role in Norway's economic success (Larsen, 2006).

Botswana offers another testimony on the importance of constituencies. In the pre-colonial period tribal institutions encouraging broad participation existed. Coincidentally, tribal institutions have not been changed much during the colonial era mainly due to the marginal importance of the territory for the British Empire. These institutions, as well as reasonable policies implemented by the first presidents played an important role after the discovery of diamonds preventing diamond revenues from being misused (Acemoglu et al., 2001).

Bearing in mind the detrimental consequences that resource rents bring, failures associated with implementation of mainstream policy recommendations, as well as the new knowledge about the importance of constituencies and domestic demand for sound policies, number of scholars have been pondering upon how to tackle the problems. The need for alternative policy suggestions has been exacerbated by the fact that number of poor developing countries, most of which are situated in Sub-Saharan Africa, that have not historically been traditional mineral resource producers have recently discovered new reserves of non renewable natural resources, especially oil (Moss, 2011). As a result some scholars (for example Segal, 2011; Moss, 2011; Sandbu, 2006; Birdsall and Subramanian, 2004) have come with an alternative suggestion to combat the abovementioned problems - direct distribution of oil rents to the citizens in the form of cash transfers.

### **3. Direct distribution of resource rents through cash transfers**

As has been previously argued evidence suggests that large resource revenues in government coffers have proven to be detrimental for growth and development in many resource dependent developing countries. This happens to be the case in countries with poor institutions, high corruption and bad governance. At the same time however, external attempts to improve the very factor that affects development outcomes have been largely unsuccessful. Distributing resource rents directly to citizens is therefore sometimes regarded as the last resort, representing not only potential to alleviate the tremendous difficulties with the management of the natural resource rents, but it could at the same time significantly contribute to reduction of poverty and perhaps inequality.

#### **3.1 Rationale for resource financed cash transfers**

##### **3.1.1 Origins of the proposal**

Recommendation of this kind appear to be the result of disappointment with how resource rents have been used in resource rich developing countries on one hand and popular conditional cash transfers (CCT) that been gaining on popularity in recent years on the other. CCT have been successfully implemented notably in Latin American countries. One of the most common examples of successful CCT programme can be found in Brazil where a programme called Bolsa Escola (later renamed to Bolsa Família) has achieved remarkable success (Kakwani, et al., 2005). Originally targeted on education the programme later included other kinds of social assistance and includes more than 12 million families (Kakwani, et al., 2005; Moss, 2011). Another successful and widely known example is represented by a Mexican CCT programme Oportunidades (previously known as Progresa). As evaluations show (for example Fernald et al., 2008; Fernald et al., 2009) the CCT programme has contributed to the improvement of a number of indicators of child health and nutrition. Due to its success in Latin America, cash transfers have been regarded as a potential development intervention in African countries as well (Kakwani et al., 2005). Besides CCT, other forms of cash transfer, mostly on unconditional basis are very common especially in developed countries. Pensions, child allowances and other benefits for instance, are the most ordinary examples (Moss, 2011). In South

Africa for instance the South Africa Child Support Grant – unconditional cash transfers programme dedicated for supporting children – has yielded very positive results as well (Agüero et al., 2007). Various types of cash transfer programmes have been also implemented in other African countries including Sierra Leone, Nigeria, Ghana, Botswana and Malawi (Nair, 2012; Gelb and Decker, 2011). These programmes are usually of limited scope and on a local rather than national level.

Likewise, sharing resource rents as such with citizens is not new. Many oil exporting countries often choose to transfer oil rents to their citizens *indirectly* in a variety of ways. This includes cheap fuel policies in which governments do not levy tax on fuels or directly subsidise it, provision of guaranteed public employment with large benefits, or low taxation in general (Gelb and Grasmann, 2010; Gelb and Majerowicz, 2011). However, such indirect transfers have several shortcomings. First, although cheap fuel policies may help overcome sharp rises in oil prices on one hand, they incur high implicit costs equal to several per cent of GDP<sup>22</sup> on the other (Gelb and Grasmann, 2010). Besides the fact that cheap fuel policies are fiscally unsustainable, they may also lead to increased consumption and smuggling (Gelb and Majerowicz, 2011). Second, lower general taxation is not only costly, but renders governments less accountable due to reduced motivation of citizens to monitor their activities (Gelb and Grasmann, 2010; Sandbu, 2006).

On the contrary, the rationale behind the direct transfers of rents to citizens in the form of cash transfers is as follows. If the performance of resource rich countries is worse than that of the resource poor, then the solution is to take the resource rents from the governments so that they do not have access to it and thus convert an economy that is based on natural resource revenues into a “non-resource economy”<sup>23</sup> (Sala-i-Martin and Subramanian, 2003). One way of doing this is to directly transfer the resource rents to the citizens in the form cash transfers (ibid.). Besides obvious immediate income poverty reduction emphasised by Segal (2011), the approach is also believed to contribute to development through its indirect effects on governance. Namely, by not being able to access resource rents directly, governments will have to collect their income by taxing. As will be explained in

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<sup>22</sup> As calculation of Gelb and Majerowicz (2011) for Uganda – one of the future oil exporter-- show, zero taxes on fuels alone would incur cost in form of foregone gain accounting for 2% of GDP.

<sup>23</sup> This is not to suggest that the resource revenues would disappear but distributing them among citizens would simulate conditions in which governments cannot rely on resource rents as in the case of resource poor countries.

further analysis, the need to tax may increase government's motivation to provide public services as well as provide incentives to citizens to monitor the use of public money and creating domestic demand for good governance (for example Sandbu, 2006; Devarajan et al., 2011; Sala-i-Martin and Subramanian, 2003). Besides economic reasons there is also a moral argument for resource revenues presented by Segal (2011, p. 477):

“The definition of rents implies<sup>24</sup> that no individual has a special moral claim to them, since those whose input is required to produce the rents have already been paid their market rate. It is therefore plausible that the only fair distribution of resource rents is an equal distribution between all owners of the resource, which is to say all citizens of the owning country.”

Only limited number of countries have so far implemented policies that would directly link resource rents and cash transfers. Some of the few examples are Mongolia and Bolivia which have used part of their resource rents to finance targeted cash transfers for children and pensions respectively (Moss, 2011). Nevertheless, Alaskan model of the Permanent Fund Dividend (PFD) is perhaps the most similar to the one that has been suggested for developing countries and indeed very often picked as an inspiration for policy proposals as well as an example for resource rich developing countries to follow. The PFD programme now annually distributes more than a thousand dollars to every citizen<sup>25</sup> on universal basis which accounts for more than 6% of personal income (APFDD, 2011; Goldsmith, 2001). The need for the creation of the Permanent Fund<sup>26</sup> emerged shortly after the initial revenues from auctioning oil leases had been wasted on unproductive capital projects (Anderson, 2002). As a constitutionally protected principal a minimum of 25 percent of earnings generated by the resource sector was to be deposited into the fund that could only be used for income producing activities further discouraging unproductive public investments (Goldsmith, 2002). To protect the deposits even further, Governor Hammond spearheaded the efforts to create the PFD. He

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<sup>24</sup> Rents refer to the excess of revenues over costs and normal profit.

<sup>25</sup> Although originally only citizens residing in Alaska for more than 25 years were eligible for dividend payments, the rule was found unconstitutional in 1982. Currently all Alaska citizens are eligible for PFD payments (Anderson, 2002).

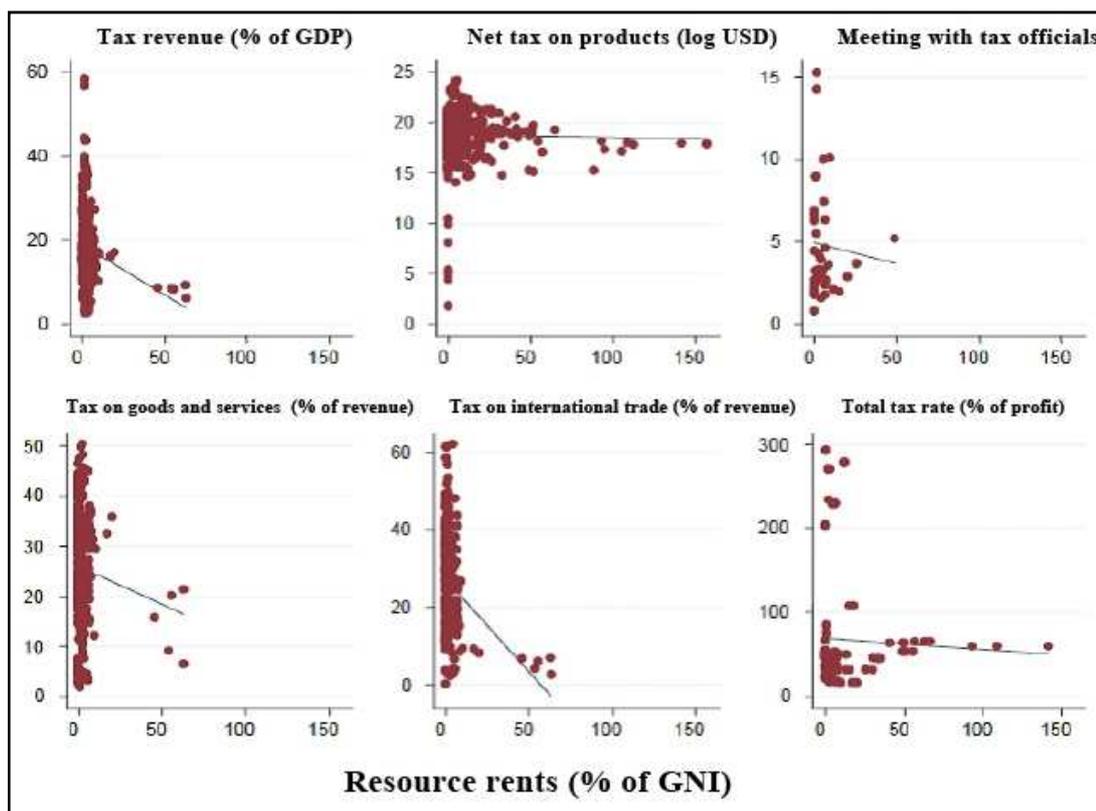
<sup>26</sup> The Permanent Fund is the Alaskan saving and investment natural resource fund. Part of its earnings is distributed as PFD on an annual basis (Anderson, 2002).

maintained that direct distribution of the proceeds from the Fund's investments to the citizens would increase their stake in the management of the oil wealth and thus protect the proceeds from being misused (Anderson, 2002). Indeed he was right. The establishment of the PDF in 1976 which distributes fifty percent of the Funds' earnings to citizens has created powerful constituencies which have so far prevented any changes in the model (Anderson, 2002; Goldsmith, 2002). The political pressure even prevented the government from spending the other fifty percent of the earnings to which was entitled by law. Thus the earnings have been added to the Fund's principle which has now higher value than the actual government's oil revenues (Anderson, 2002).

Although as Hjort (2007) argues that realities of Alaska cannot be compared to those of Africa, the fact that PFD has led to the creation of powerful constituencies in favour of sound oil rent management that did not exist before remains unchallenged (Goldsmith, 2002). This might be considered as perhaps the most important lessons learned for similar suggestions for African countries which are indeed much different from Alaska. At the same time however, Alaskan model is often criticised for shortcomings including low or nonexistent taxation that is common in resource dependent countries and according to many authors (for example Devarajan et al., 2011; Sandbu, 2006; Segal, 2011) one of the most important impediments for accountability and good governance.

### **3.1.2 The importance of taxation in the process of rent distribution**

As has been argued in previous chapters, large inflow of oil rents in governments' coffers significantly lowers the governments' motivations to tax. Indeed, as Bornhorst et al. (2009, cited in McGuirk, 2010, p.5) argue, 1% increase in natural resource revenues is correlated with 0.2% decrease in non-resource revenues. The situation in Sub-Saharan Africa is illustrated by McGuirk (2010) who offers a cross country analysis showing the correlation between the amount of resource rents as percentage of GNI and different tax rates. As shown in figure 4 (p.39), resource revenues are negatively correlated to several measures of aggregate taxation.



**Figure 4:** Relationship between taxes and natural resource rents in Sub-Saharan Africa, 1960–2000 (McGuirk, 2010).

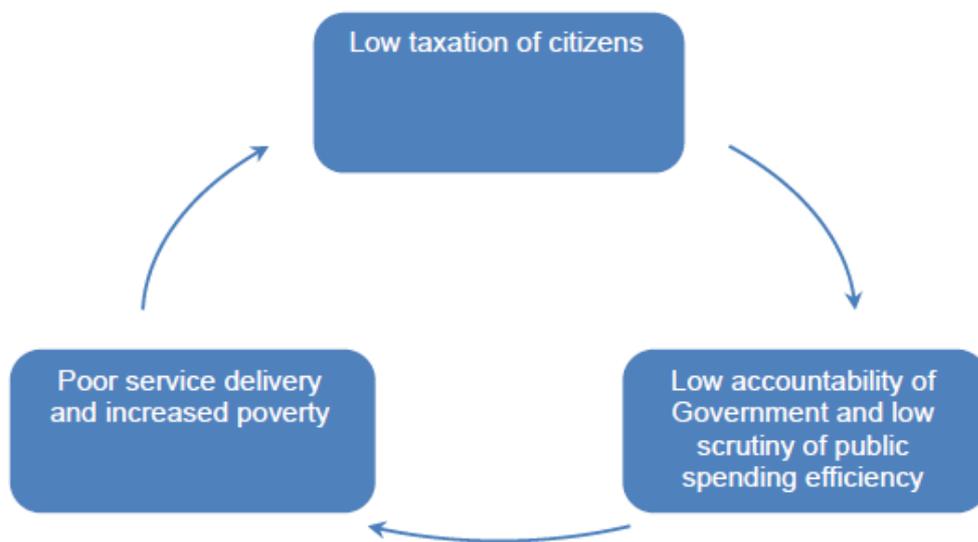
Lower taxation not only incurs implicit fiscal costs in terms of loss of potential income, but it also impedes the quality of governance (Moore, 2007). This happens through erosion of what has been referred to as fiscal contract<sup>27</sup> in which citizens accept to pay taxes in return for the right to oversee management of public resources, in other words for holding the governments accountable (OECD, 2008). Nonexistence of this fiscal contract has several implications. If governments, due to easy access to unearned income in form of oil rents, do not need to tax their citizens, they are not motivated to provide public services. In such situation therefore governments remain largely unresponsive to the needs of the citizens. In the words of Birdsall and Subramanian (2004, p.87)

“When the marginal cost of raising public resources is virtually zero, governments have little incentive to manage well, provide adequate public services, respond to citizens’ demands, or invest

<sup>27</sup> In the literature the term fiscal contract (used for example by Devarajan et al., 2011) has been interchangeably used with terms social contract (Moss, 2011) or fiscal social contract (OECD, 2008).

in and sustain the software of market economies and good governments.”

On the other hand, citizens, because they are not taxed, have no incentives to scrutinise government’s activities (McGuirk, 2010). The abovementioned *demand* for accountability and good governance is therefore missing. This, according to Devarajan et al. (2011) creates vicious cycle that perpetuates low budget transparency, poverty, poor service delivery and bad governance in resource (and especially oil) dependent developing countries (figure 5).



**Figure 5 :** The vicious cycle of resource rich economies (Devarajan et al, 2011)

The importance of strong fiscal contract has been confirmed by a number of historical examples. While it played an indispensable role in building democratic states in Europe, taxation systems in Asia led to higher efficiency of public spending. Countries of Latin America where fiscal contract is established show good results in terms of good governance as well (OECD, 2008). It could therefore be argued that:

“[T]ax is not the sole determinant of rapid development but it is one pillar of an effective state, and may also provide the basis for accountable and responsive democratic systems (OECD, 2008 p.17).”

And since according to Devarajan et.al. (2011) African oil exporters especially seem to show symptoms of nonexistent fiscal contract in terms of low accountability, low transparency and corruption, it is particularly needed in African resource economies to re-build it if they want to break the vicious cycle.

Direct distribution of resource rents to citizens in the form of universal cash transfers provides incentives for the formation of a fiscal contract (Gelb and Majerowicz, 2011). Taking rents from governments will turn resource economies into “non resource economies” forcing governments to find other sources of income by taxing (Sala-i-Martin and Subramanian, 2003). As a result, fiscal contract is likely to emerge creating demand for better management of taxed resources, ultimately leading to better governance, accountability, provision of public services and better development outcomes (Moss, 2011; Devarajan et al., 2011). How exactly the taxation will be carried out and what are its implications and how the potential positive effects emerge will be discussed in subsequent chapters.

### **3.2 Designing the resource financed cash transfers – schemes and considerations**

As it has been previously mentioned, the idea of direct distribution of resource rents in the form of cash transfers has only recently gained on popularity. The number of specific schemes that have been developed so far is therefore not very high. The most prominent redistribution schemes which could be applied to African countries include Paul Segal’s concept of *the Resource Dividend* (Segal, 2011), Todd Moss’ *Oil to Cash* concept (Moss, 2011; Moss and Young, 2009), Martin E. Sandbu’s idea of *Natural Wealth Accounts* (Sandbu, 2006), model of Sala-i-Martin and Arvind Subramanian (Sala-i-Martin and Subramanian, 2003) and some others. Although all of them share the same keynote, they differ in several aspects. These nuances are related to various implementation details such as what resources will be distributed, who will be in charge of the distribution, how much of the rents will be distributed, in what way will governments regain the lost rents, how will transparency be secured, who will be eligible for cash transfers and so on. Therefore for the sake of feasibility and effectiveness the models will have to be combined and adjusted. Since the policy design is not strictly predetermined it will also require adjustments

so that it matches the country specific context. Local (in this case national) ownership in formulation and implementation of cash transfer policies will play a very important role (Sala-i-Martin and Subramanian; 2003).

### **3.2.1 Resource rents and its distribution**

There are several fundamental questions regarding the resource rents per se and its distribution to citizens that have to be considered. One of the questions is what to distribute. Although the answer may be seem obvious, there are at least two options. In the case of Alaska resource rents are invested through the Permanent Fund and only the return on the investments is redistributed among the population (Anderson, 2002). This model is most likely not a feasible alternative for African resource exporters given the weak institutional environment and negative experience with resource funds in African countries illustrated in previous chapters (Sala-i-Martin and Subramanian, 2003). For these reasons there is general agreement among scholars that the rents alone will have to be distributed.

Another question regarding how much or what portion of the rents should be distributed brings more variations into the discussion. Devarajan et al. (2011) for example implicitly suggest distributing only part of the rents. Moss and Young (2009) on the other hand work with two alternatives in their proposal for Ghana. While the first variant is to distribute 100% of resource rents, the other one allows for using part of the revenues for other purposes (ibid.). The suggestion to use part of the rents for other purposes perhaps takes into account the fact that distributing full amount of rents will be politically difficult in countries where other uses of money<sup>28</sup> may be politically more attractive. Nevertheless this alternative could probably lower the positive impacts of the whole policy. Sandbu (2006) explains the notion building on the assumption that rents represent unearned income which corrupts governments. If the amount distributed was low (say only 25%) that the remaining rents are still the same unearned income which in the hands of governments would negate the potential positive effects of the policy (ibid.). Gillies (2010) adds that in the case of small scale distribution the motivation to tax would be equally undermined. Sandbu (2006) therefore considers ideal distributing all of

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<sup>28</sup> For example building infrastructure which is indeed much needed in African countries (Gelb and Majerowicz, 2011)

the rents to citizens and regaining a part of them by taxing immediately afterwards. To ease the political burden of having to give up all the rents at once, Sala-i-Martin and Subramanian (2003) allow for transition period during which the amount of rents redistributed would increase gradually and at the end of which 100% of rents would be distributed. However if for the sake of political feasibility only a part of the rents was to be transferred, the redistributed portion should be as close to 100% as possible.

Knowing what portion of rents is ideal to distribute third question arises, and that is, what would be the amount of rents redistributed in per capita terms<sup>29</sup> and consequently how much will resource financed cash transfers contribute to household budgets in individual countries. This question will be discussed in detail in subsequent chapters.

### **3.2.2 Taxation**

Taxation is indeed the most important point of the whole proposal of the resource financed cash transfers. In fact, almost all the goals that the policy aims to achieve are to be reached through the positive effects of taxation on governance, accountability, state building, i.e. through (re)building the social contract between governments and citizens.

As has been argued, the main idea is to virtually convert a resource economy into a non-resource economy and implicitly force the government to regain the lost - in this case the distributed - income by taxing (Sala-i-Martin and Subramanian, 2003). Although the immediate “loss” of easy income may seem tragic for governments concerned, the fact is that all resource poor countries face the same situation and, as has been shown, fare much better in terms of economic development (ibid.).

Even though the importance of taxation is central to all the resource financed cash transfers schemes the views on what to tax substantially differ. For example Sala-i-Martin and Subramanian (2003) would implicitly let governments determine potential sources of tax revenues. They argue that absence of rents in the

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<sup>29</sup> Calculating the amount of cash transfers in per capita terms is only for illustrative purposes and is not to say that every person should be eligible for cash transfers. Eligibility for cash transfers will be discussed below.

governments' budgets will provide strong incentives to find sources of income elsewhere. This would represent a stimulus for broadening tax base and for increasing the collection of taxes. This approach however may lead to several political and economic difficulties. Baunsgaard and Keen (2005, cited in Segal, 2011 p. 484) present empirical evidence that countries which liberalised their trade have had difficulties to compensate for the lost income. They show that low income countries have been able to regain only 30 percent of their income through other forms of taxation while middle income countries from 45 to 60 percent. If this was the case of African resource exporters which are predominantly low income and lower middle income countries, convincing governments to implement resource financed cash transfers might be challenging (World Bank, 2011; World Bank, 2012b; Segal, 2011).

On the other hand Segal (2011), Gelb and Majerowicz (2011), Sandbu (2006) and others suggest that resource financed cash transfers would be treated as a normal income and taxed immediately after disbursement to partially compensate for the lost revenues. Although such taxation may be regarded as pointless and wasteful, it is very important since it will convert unearned income (i.e. resource rents) into "earned" income (i.e. taxes). Gaining part of the revenues in this way is supposed to create sense of ownership and increase citizens' stake in the management of the financial resources and lead to other positive effects of taxation further discussed below (Sandbu, 2006). Taxing rents as normal income may also render the resource financed cash transfers more politically feasible by ensuring that certain amount of resources will be delivered back to the governments' budget.

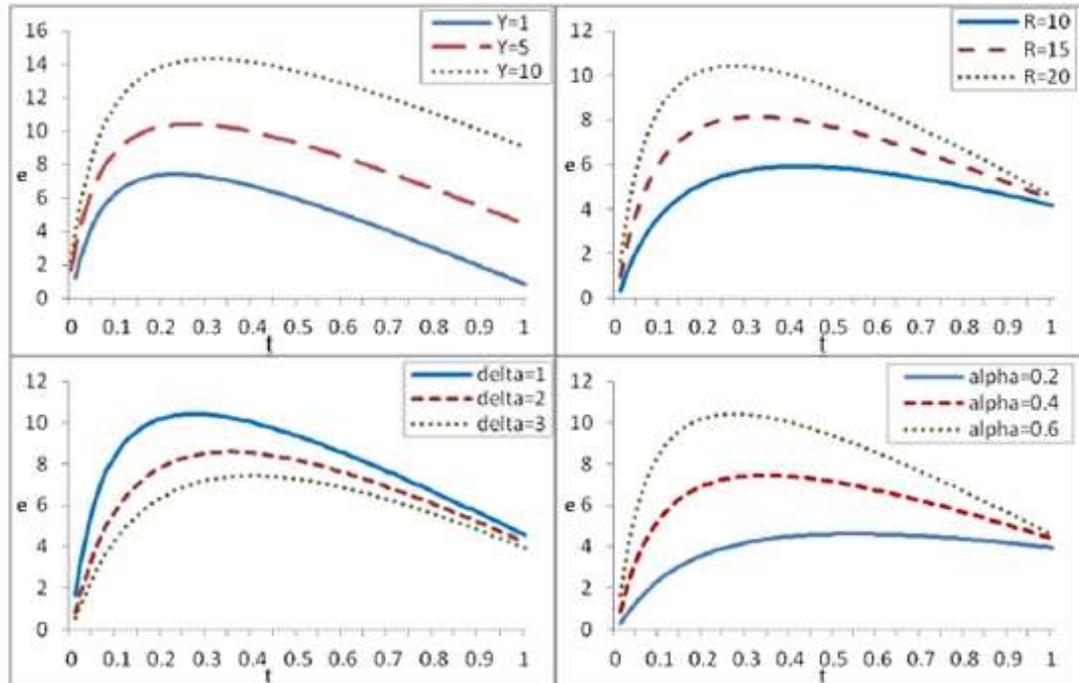
As for the design of the taxation scheme there are two main issues to consider. The first issue is related to how the taxation will be carried out or in other words in what way will the governments collect the tax from the cash transfers. Sandbu (2006) provides general yet the most detailed analysis of this issue presenting three different variations. In all the cases Sandbu proposes a creation of so called natural wealth account for every citizen to which the transfers would be allocated. In the first alternative which Sandbu (2006) describes as a "soft" governments would tax the transfers prior to the distribution and would only distribute the remainder. Second alternative which could be described as an intermediate version would include distribution of the whole amount and the tax would be then sent back by the citizens. Third version, which Sandbu (2006) calls

“extreme”, separates the cash transfers from tax payments. For example the beneficiaries would be required to pay the tax from the cash transfers on a certain date different from the one of resource financed cash transfer disbursement. There are several tradeoffs between these models regarding especially their impact on the citizens’ motivation to scrutinize their governments, transaction costs, feasibility and possibly the rate of potential leakages. While the extreme version would imply stronger effects on governance and the creation of fiscal contract on one hand higher transaction costs and perhaps leakages render this alternative less feasible. “Softer” alternatives are therefore more suitable in the case of Sub-Saharan Africa. Although the effects of taxation would be lower, it may still be considerable. It must however be ensured that the beneficiaries know how much money is being withheld from them (ibid).

Second issue is related to the tax rate that would be used in taxing the resource financed cash transfers. Here, Sandbu (2006) argues that even if the tax rate was 100%, the conversion of unearned income into tax revenues would be beneficial. Such scheme would however deprive citizens of potential income and halt other prospective cash transfer benefits. Devarajan et al. (2011) go further into the analysis of optimal tax rate. They agree that in countries with no or very low levels of taxation increasing the tax rate would yield positive results in form of higher effort of citizens to scrutinize governments which in turn would contribute to better provision of public services by the governments. Theoretical model developed by Devarajan et al. (2011) and presented in figure 6 (p.47) however shows that this relationship is valid only for tax rates up to a certain threshold after which the citizens’ monitoring effort starts to decrease. Although as shown in figure 6, the motivation of citizens to exert effort on monitoring the governments depends on several factors, its tendency to decrease after the taxation exceeds the taxation levels between approximately 20 and 40 percent is evident in all cases.

For  $R=20; \alpha =0.6; \delta =1; \gamma =1$

For  $R=20, Y=5, \delta =1, \gamma =1$



For  $R=20; \alpha =0.6; \delta =1; \gamma =1$

For  $R=20, Y=5, \delta =1, \gamma =1$

**Figure 6:** Simulation of the relationship between taxation rate  $t$  and monitoring level  $e$  for different levels of related parameters.

**Notes:**  $R$  – resource revenues,  $Y$  – citizens’ income,  $\delta$  – opacity over the government budget i.e. how difficult it is to get the information about the government revenues,  $\alpha$  – share of the rents that is redistributed among citizens (0=0%, 1=100%),  $\gamma$  – monitoring effectiveness

**Source:** Devarajan et al. (2011)

In reality setting appropriate tax rate will for example depend on the amount of cash transferred to citizens and hence citizens’ income. For example in the case of Equatorial Guinea which is a country with vast oil rents and small population, resource financed cash transfer per capita would be much higher than for example in Sierra Leone where resource rents are disproportionately lower (Goldman, 2011; Nair, 2012). Analogically, the tax rate could be much higher in Equatorial Guinea inducing the same monitoring effort as in the case of lower tax rate in Sierra Leone. Apart from the monitoring effort, taxation also influences other variables such as the amount of cash transferred to citizens or the amount of resources that the government regains and uses for different purposes. There is therefore a trade-off among these variables which should be taken into account when determining the tax

rate in a specific context. In any case, the collected taxes will be lower than the original resource rents and it is therefore imperative for governments to find other sources of income, preferably by broadening tax base.

Finally, Sala-i-Martin and Subramanian (2003) and Sandbu (2006) suggest that taxing resource financed cash transfers could alternatively be the role of federal or local governments. This would potentially provide incentives for decentralisation since the fiscal contract – that is paying taxes in return for provision of services – would move more towards the local level. This step would also encourage fairer resource allocation since federal governments would have access to equal tax base in per capita terms and would be free to choose their own tax rate, presumably from a range defined by national law. As Sala-i-Martin and Subramanian (2003) argue, in Nigeria this model could serve for example to compensate the resource producing regions for losses they suffer due to resource extraction and alleviate the tensions that arise out of the current revenue sharing system of the central government. It must be acknowledged however that implementation of taxation on federal/local level may be problematic in some countries. An analysis of Ugandan<sup>30</sup> realities presented by Gelb and Majerowicz (2011) for example shows that local governments suffer from extremely low capacities and face severe corruption problems. This model therefore would not be feasible in Uganda and taxes would have to be collected by central government exchanging decentralisation for relatively better tax collection and service provision. This issue therefore has to be again considered based on specific local context.

### **3.2.3 Administrative and logistical issues**

Implementation and administration of resource financed cash transfers will very likely, if not certainly, be accompanied by several logistical and administrative difficulties. Such concerns have been expressed by majority of scholars dealing with direct resource distribution including Gelb and Majerowicz (2011), Gillies (2010), Sala-i-Martin and Subramanian (2003), Hjort (2007) and others. Potential difficulties will probably result from inadequate capacities leading to problems with national identification, transaction systems and low transparency and corruption

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<sup>30</sup> Uganda is expected to become one of the oil exporters and is considered as one of the candidates for implementation resource financed cash transfers (Gelb and Majerowicz, 2011).

potentially leading to leakages. These problems will have to be addressed so that the implementation and operation of the programme runs as smoothly as possible.

There are several administration and logistical details on the way from obtaining the resource rents by governments to the beneficiaries in the field that are being considered. At the very beginning at the national level, issues about how the resource rents will be handled are debated. Several sources (Segal, 2011; Sandbu, 2006) suggest that the distribution of resource rents should be managed by an independent office. At the same time, it has been suggested that the rents need to be put in a separate account isolating them from general government budget to prevent the rents from being allocated for other undesirable purposes. The account could be simultaneously used to smooth the distribution of rents and to counter the resource price and revenue volatility<sup>31</sup>. The amount of cash transfers could be determined on the basis of several years average prices of resources<sup>32</sup> or, alternatively as a percentage of GDP (Gelb and Majerowicz, 2011; Moss and Young, 2009). The remainder would then be saved in the account and used in times of lower prices (Sandbu, 2006). Second alternative, is to smooth only the government revenue through taxation of the cash transfers so that the tax revenue would be constant (ibid.). In this case the citizens would have to accommodate to the cash transfer volatility. As Segal (2011) and Sandbu (2006) argue, private agents are much more capable to effectively resist the income volatility than the public sector. While public sector often resorts to ineffective and wasteful investments in the time of high income, private agents accumulate more savings. If this advantage of private agents over public is to be exploited, this alternative should be used.

To lower administrative costs and reduce leakages and logistical burdens, payments will probably have to be distributed less frequently, for example annually or 6-monthly (Sala-i-Martin and Subramanian, 2003). While cash transfer disbursement will be administered by an independent office, taxation should be exclusively the role of governments, be it central or local (Sandbu, 2006). Having

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<sup>31</sup> Although it has been argued that natural resource funds that are commonly used in many resource rich countries may be prone to misappropriation this would be a different case. The account will be directly joined to the system of resource financed cash transfers and creating incentives for citizens to monitor the management of resources deposited analogous to the case of the Alaskan Permanent Fund.

<sup>32</sup> Such system of determining the amount of cash transfers is used in Alaska where five year averages are taken into account (Goldsmith, 2002)

solved the handling of the rents at the national level more challenges may arise when getting closer to beneficiaries. There are two main components that have to be in place not only in the case of resource financed cash transfers, but in any cash transfer programme in general. First, system for identification of beneficiaries has to be in place to identify citizens eligible for cash transfers and to avoid potential abuses. Second, a system for facilitating payments is necessary to transfer cash transfers to the beneficiaries (Gelb and Decker, 2011).

There are several ways in which the first indispensable component of successful cash transfer program – effective identification system – can be put into practice. In any of the following cases, biometric technology may play an important role. In fact, biometric identification – especially fingerprints – has been commonly used in small scale cash transfer and other programmes across African countries including Nigeria, Ghana, Kenya and Malawi (Gelb and Decker, 2011). While providing potential for significant cost reduction, these technologies can be used even in countries with capacity constraints (ibid.).

One of the specific schemes for identification of beneficiaries may be to require each citizen to hold a national ID card. Although such requirements may seem difficult to accomplish in African context, it may in fact not be so hard to achieve. In Sierra Leone for example governments programme for issuing biometric ID cards has been under way since 2009. Although there have been some delays the government intends to complete the project in 2015 (Nair, 2012). Another option presented for example by Sala-i-Martin and Subramanian (2003) is to use voters ID cards. Thus eligible citizens in order to receive their share would be required to register on electoral rolls. There are several advantages of this option. Voter ID cards would be regularly updated depending on the length of the election cycle and at the same time the scheme could have positive spillovers in form of higher election participation (ibid.). Third option suggested by Sandbu (2006) is to use birth certificates as a proof of eligibility for payments.

Transferring money to eligible citizens, as another essential component of a cash transfer programme, may also be challenging. Nevertheless several options have been considered. Probably the most convenient yet unrealistic is to demand each citizen to have an ordinary bank account to which the cash would be transferred (Sala-i-Martin and Subramanian, 2003). Due to low penetration of financial services in African countries, and scattered rural population which do not

have access to them, this suggestion has to be turned down. To accommodate demands of that part of population that does not have access to ordinary financial services coupon like vouchers could be used to distribute cash transfers.

Another option is to transfer money via post checks (ibid.). Even the network of post offices however may not be sufficient and may require beneficiaries to travel large distances. Therefore Gelb and Decker (2011) present a set of alternative money transfer systems that are commonly used also in African countries. For example, special account could be created for every eligible citizen, to which the money would be transferred and would be then accessible via mobile stations. Alternatively, these accounts could be also accessed which grocery stores or other vendors. Vendors could also charge a small fee which would bring market incentives into the system creating room for some profit (ibid.). Such system is widely used in India, but similar schemes are in place in number of African countries including Malawi, Botswana, Namibia and South Africa (ibid.).

Another and very promising possibility is to take advantage of increasing penetration of mobile phone services in Sub-Saharan Africa and use mobile payments for the resource financed cash transfers (Nair, 2012). One does not to go far for inspiration. In Kenya local mobile services operator Safaricom launched a very successful payment service M-PESA which allows people simply send and withdraw money using mobile phones (Hughes and Lonie, 2007). Instead of a regular bank account customers simply apply for a special M-PESA account and are then able to send and receive cash through their mobiles and Safaricom dealers (ibid.). Mobile transfers would considerably lower the costs of transfers and could be also more efficient in respect to preventing potential leakages and corruption. Indeed, there are some problems that could disqualify this option, namely the fact that electricity and mobile network coverage is still inadequate in many of the countries. On the other hand, mobile service penetration is likely to increase even further what makes mobile payments a viable option for the future (Nair, 2012). Moreover, M-PESA service provides evidence that such service can be set up despite several political, social, technological, financial and regulatory constrains (Hughes and Lonie, 2007). In the Kenyan case setting up of the service was subsidised, which could be replicated in resource rich countries using resource rents.

### **3.3.4 Targeting, conditionality and eligibility for payments**

One of the arguments for establishment of resource financed cash transfers supported especially by Segal (2011) has been its potential significant contribution to poverty reduction. In this regard scholars seem to be inspired by the CCT programmes in Latin American countries which, according to evaluations have been delivering some favourable results (Fernald et al., 2009). These CCT programmes are both targeted – dedicated to poor families – and conditional – conditioned upon certain behaviour (Azevedo and Robles, 2010). Nonetheless as evidence shows, such design would probably not be replicable in the case of resource financed cash transfers in Sub-Saharan Africa.

There are several reasons for why targeting is not appropriate in this case. First, the moral principle which the idea of the resource financed cash transfers is based upon implies, that natural resource rents belong to all citizens. Targeting cash transfers would in fact nullify this argument since they would be allocated only to one part of the population – probably the poor. Second, in the case of targeted transfers in developing countries, exclusion errors very often occur. This means that some of the intended beneficiaries are not included in the program design (Segal, 2011). This for example has been common case with the CCT in Latin America as argued by Azevedo and Robles (2010). Exclusion errors can be easily avoided by distributing the rents to all. Third, resource financed cash transfers dedicated to poor based on certain poverty line, may create disincentives for the poor to increase their income above this poverty line creating a poverty trap (Segal, 2011). Next, if the resource financed cash transfers are to induce fiscal contract preferably among all the citizens targeting the transfers could hinder such efforts. Finally, distributing resource rents only to a certain part of the population may result in severe conflict over the eligibility criteria making the policy infeasible.

Conditionality also plays an important role in the case of Latin American CCT programmes. In one regard by allocating cash transfers only to those families that make some effort to comply with the requirements, conditionalities serve as a justification for targeted transfers. However, if proposed resource financed cash transfers were universal and not targeted such justification is not needed. At the same time, conditionalities are used predominantly to boost investments to human capital in children in beneficiary families. Indeed improvements in schooling and

health indicators in Latin American countries implementing CCT are commonly attributed exactly to the conditionalities. However, this again does not mean the model could be used in the case of the resource financed cash transfers in Sub-Saharan Africa. The difference between Latin America and Africa is well expressed in Schubert and Slater (2006) who argue, that the CCT-like conditionalities would not be replicable in low income African countries due to potential constraints on the supply side. While the cash transfers in Mexican Oportunidades for example, are conditioned upon sending children to schools and visiting health centres (Fernald et al., 2009), empirical evidence from some countries<sup>33</sup> of Sub-Saharan Africa suggests that in low income countries schools and health facilities often do not have adequate capacities to satisfy increased, conditionality-induced demand. Remote rural areas are especially problematic in this regard (Schubert and Slater, 2006). Another disadvantage applies equally for targeting and conditionality. Selecting eligible beneficiaries and monitoring compliance increase the costs of delivery per beneficiary and therefore makes the programme less efficient. Moreover, conditional and targeted cash transfers would be logistically more demanding. Due to limited implementation capacities<sup>34</sup>, conditioning would not be adequate. In addition to that, Segal (2011) argues that conditional cash transfer schemes may be more prone to clientelism and corruption since officials in charge may favour certain groups of citizens over another.

Despite the fact that the conditionalities in Latin American CCT programmes played an important role in delivering positive results, empirical evidence shows that unconditional cash transfers may also lead to remarkable development outcomes. Research of Baird et al. (2011) from Malawi shows that while conditionalities lead to significant improvements in those indicators that are closely associated with the specific conditionality (for example school attendance) improvements in other indicators were negligible. Unconditional cash transfers lead to significant improvements also in other important indicators which as will be further analysed in following chapters.

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<sup>33</sup> Schubert and Slater (2006) show evidence from conditional cash transfer experiments in Zambia and Malawi.

<sup>34</sup> Limited implementation capacities are regarded as one of the most significant obstacles for the implementation of the resource financed cash transfers in Sierra Leone (Nair, 2012) and Uganda (Gelb and Majerowicz, 2011).

Judging from all of the above arguments it is preferable that resource financed cash transfers not be targeted and conditional. If conditionalities occur they should be few in number and universal in nature so that they allow everyone to take part in the programme. For example registration in electoral roll or acquiring national ID cards serving for programme facilitation may be used as a condition for payments as well (Gelb and Grasmann, 2010; Sandbu, 2006; Nair, 2012).

Another implementation issue which will have to be dealt with is who will in effect receive payments. Although the fundamental idea of and the moral argument for the resource financed cash transfers implies distribution resource rents to all citizens without exceptions, the issue is far from simple and has to be carefully considered. In the case of Alaskan PFD for example, dividend is distributed to all Alaskans including children, whose share is given to their parents as trustees (Goldsmith, 2002). If this was the case in African resource exporting countries, it could potentially serve as a pro-natal policy providing incentives for having more children and thus increasing fertility which would definitely not be desirable in the case of Sub-Saharan Africa (Sala-i-Martin and Subramanian, 2003). Likewise in the case of Mexican CCT programme Oportunidades in which payments are disbursed to female heads of households the amount of cash is adjusted according to the number of children, which again provides incentives for fertility which is not desirable in the African context (Fernald et al, 2009; Sandbu, 2006). Moreover, although there may be some efficiency gains when distributing cash to female heads of households, this may prove unacceptable in some African countries due to different cultural context (Sala-i-Martin and Subramanian, 2003). Judging from what has been said distributing cash transfers to every adult citizen seems to be the most suitable option (ibid).

### **3.2.5 Ensuring transparency and reducing leakages**

As has been mentioned, African resource exporters will very likely face administrative difficulties if they choose to implement the resource financed cash transfers and measures will have to be taken to minimize them. At the same time it is unlikely that omnipresent corruption and lack of transparency in public finances typical of resource exporters would disappear overnight. Therefore, potential corruption and leakages have to be taken into account. As argued above one of the

potentials and aims of the concept of resource financed cash transfers as such is to improve governance by creating demand for better management of public resources and increasing the monitoring effort of citizens. However, without knowing what should be the amount of the cash transfers citizen can hardly find out that they are being deprived of their share. Access to information is therefore crucial for the whole scheme of the resource financed cash transfers. Hence, initiatives and instruments to support dissemination of information and to ensure that needed information get to the beneficiaries will be crucial part of the programme.

One instrument that provides a great inspiration for similar initiatives associated with the resource financed cash transfer programmes is the Public Expenditure Tracking Survey (PETS). PETS is a tool commonly used in development programmes and projects in Africa and elsewhere to track the flow of public resources from origin to the destination by informing citizens as the beneficiaries about how much of what they should get (Koziol and Tolmie, 2010). Thanks to this instrument, citizens as beneficiaries are able to monitor the delivery of the project and demand better results. PETS have achieved some impressive result in improving the transparency of resource allocation and reducing leakages in various projects and programmes.

Svensson (2006) presents an observation from a grant programme in Uganda which was supposed to cover non wage expenditures in education. However, despite significant increases in expenditures, no improvements in relevant indicators were recorded. As later came out, only 13% of resources had been on average effectively delivered to schools, while some of the schools did not receive anything. The main reason for such drastic leakages was that the beneficiaries had neither any information about the amount the resources that should be delivered, nor did they know about the programme per se. The implementation of PETS included publishing data in national newspapers and schools. At the same time schools were asked to publish what they receive. By comparing the data it was found out that as much as 80% of finances had been delivered (ibid.). This provides valuable evidence on the importance of information for effective monitoring of governments by the citizens.

While PETS have been employed in development projects and programmes there is a strong analogy with the resource financed cash transfers. Here initiatives

like the Extractive Industry Transparency Initiative (EITI) may play an important role similar to the one of PETS in developing projects (Nair, 2012). Although it has been previously argued that the effects of EITI on governance have been weak so far, with few improvements it may become a valuable tool for cash transfer monitoring. The main problem of the initiative so far lies in the fact that it does not create domestic demand for transparency and accountability (Moss, 2011). The reason for this is that stakeholders involved in resource extraction including governments and companies provide the information about their payments to independent auditors rather than to the citizens. Therefore if the information about resource rents and the amount of cash transfers were made available to citizens, they would be able to compare the information with the actual transfer and demand greater transparency in the process of cash transfer distribution. As has been mentioned in the previous chapters, information about how much of the cash transfers has been taxed will be equally important for the creation of demand for sound management of the government revenues which will be generated by taxes (Sandbu, 2006).

## **4. Resource financed cash transfers in practice – impacts, problems and feasibility**

### **4.1 Potential impacts of direct distribution**

The proposal of the resource financed cash transfer has been coined as an alternative to conventional economic suggestions for natural resource management which in Africa have largely failed. The policy is therefore expected to counter some of the political economy difficulties. However, this is only one part of its potential positive effects. Since the direct distribution involves transferring large part of government revenues to citizens, it would also have considerable direct economic and social effects.

#### **4.1.1 Impacts on governance and political economy**

As has been shown in previous chapters the natural resource curse is a matter of political economy since the resource rents that come unearned tend to corrode the quality of governance and institutions. The resource finance cash transfers is a policy that represents a potential to reverse this negative tendency of resource rents through re-establishing of the social contract between citizens and governments. Thus, the policy is believed to have a number of positive effects on governance.

The main factor which induces majority of the positive effect on governance is taxation, which as has been argued, is an indispensable part in the design of the direct distribution of resource rents. Levying taxes which will have to be in place if governments implementing the resource financed cash transfers want to regain the lost income, will invoke greater demand for accountability from the citizenry. This is likely to happen because of two major effects of taxation. The first effect Sandbu (2006, p. 1159) refers to as “the endowment effect”. In other word taxation creates a sense of ownership of the public funds among the population (Moss and Young, 2009). The reasons why this effect is likely to occur in the case of the resource financed cash transfers are as follows. Findings from behavioural economy and social psychology show, that the perception of losses is much more intense than perception of foregone gains. While misappropriation of natural resource rents is perceived rather as a foregone gain to which limited attention is paid, misusing public finances collected in taxes is regarded by citizens as loss (Sandbu, 2006).

There are therefore good reasons to assume that citizens will be more interested in what is happening with *their* money and how the money is spent. Therefore, the motivation of citizens to hold government accountable and monitor how public money is spent is incomparably higher in the case of taxes than in the case of natural resource rents (Sandbu, 2006; Moore, 2007). Further, the motivation of citizens to scrutinize government management of public resources is exacerbated by what Sandbu (2006, p. 1160) calls as “the information effect” of taxation. In resource based economy people usually do not know how much money in per capita terms government receives, spends and perhaps misuses. Direct distribution of rents in the form of cash transfers associated with taxation is likely to help citizens understand how much money government receives, and increase the demand for information about how the money is spent (ibid.).

Another potential positive impact of the direct distribution and associated taxation arises out of the fact that governments will have to “justify the taxes” (Moss and Young, 2009, p.14) and the tax rate by providing public services. If such “justification”, and thus the provision of public services, is not in line with what citizens expect they may prefer politicians that advocate lower taxes potentially threatening not only those in power, but also the government’s income. Such situation makes corruption and low efficiency more costly for governments and therefore provides incentives for better governance (Sandbu, 2006). Further, the need to tax and make tax collection more effective may contribute to the improvement of government bureaucratic apparatus and state capacity (Moore, 2007; Segal, 2011). Moreover, governments will have to rely on a broader tax base and therefore be motivated to extend the tax collection and associated provision of public services to more remote areas in comparison to the situation when they rely only on the inflow of resource rents (OECD, 2008).

Besides effects associated with taxation there is another point about the resource financed cash transfers that is related to political economy. Namely, drawing from the Alaskan experience it can be assumed that policy of resource financed cash transfers will be politically difficult to reverse. Any changes to the design which would result in allocating higher proportion of rent directly to the government depriving citizens of their share could be identified as an attempt to misuse these resources and would very likely not be accepted (Sandbu, 2006;

Goldsmith, 2002). This is in line with previously mentioned fact that citizens are especially sensitive to losses.

#### **4.1.2 Socioeconomic impacts**

Since bad governance and low quality of institutions, corruption and so forth are considered to be the main causes of weak economic and social outcomes in resource dependent developing countries, positive effects of the direct distribution of resource rents on governance should ultimately lead to improvements in the social and economic sphere in the long run. In the meanwhile however, the transfer of resource rents as such to citizens in the form of cash transfers has a potential to bring improvements in these spheres not only on the country level but also on the individual level. After all, positive social and economic outcomes are ultimate goals of any policy aiming at improving management of natural resource rents and the policy of resource financed cash transfers is not an exception. Estimating potential positive impacts however is an uneasy task since no such programme perhaps with an exception of Alaska exists. Nevertheless, some estimations can be made based on experience with other cash transfer and similar programmes.

Because the unconditional and universal distribution of resource rents in the form of cash transfers implies an increase in citizens' incomes, immediate reduction in income poverty is probably the most straightforward outcome. This outcome is especially desirable in Sub-Saharan Africa where the share of population below \$1.25 per day is close to 50% (UN, 2012). Indeed poverty reduction is considered to be one of the most important outcomes of the resource financed cash transfers by a number of scholars including Segal (2011), Gelb and Majerowicz (2011), Sala-i-Martin and Subramanian (2003), Birdsall and Subramanian (2004) and others. However the increase of household income as such is not the only important implication. By receiving a share of resource rents (i.e. certain share of government revenues) directly in cash, citizens may decide themselves how to allocate the received funds. There are good reasons to think that these resources will be more efficiently invested than if the citizen had to rely on the delivery of public service by governments. Indeed, as has been argued, governments in these countries are extremely inefficient in allocating public resources. This can be best illustrated by

observation presented by Gelb and Decker (2011), Moss (2011) and Sandbu (2006) who argue that the leakages in public service delivery may be as high as 99%<sup>35</sup> in some African countries.

The magnitude of potential immediate income poverty reduction will depend predominantly on the amount cash transferred to the citizens and this in turn depends on several variables such as number of inhabitants, prices of resources, amount of rents available for distribution, level of taxation in case the rents are taxed back and, possibly also some leakages on the way from the government to the citizens. Nevertheless some preliminary calculations have been done to determine the impact of resource financed cash transfers on personal and household budgets and immediate income poverty reduction.

Although the absolute figures are far lower than in the case of the Alaskan PFD, in the context of developing countries with high percentage of people living below the \$1.25 poverty line even lower amount will be proportionally higher and are thus not negligible. Gelb and Majerowicz (2011) for example calculated the potential amount of resource financed cash transfers if the proposal was to be implemented in Uganda as a future oil exporter and a country with GNI per capita about \$500. They found out that the cash transfer would be about \$50 per capita per year<sup>36</sup> if oil extraction estimations came true. Cash transfer could thus very likely considerably increase the income of the poorest inhabitants. In the same vein Moss and Young (2009) estimate that in the case of Ghana it would be as much as \$80 per capita. Nair (2012) presents a calculation iron ore exporter Sierra Leone where the amount of annual resource financed cash transfers would reach \$16 in 2015 which accounts for more than 5% of annual expenditure per capita. For those below the extreme poverty line the transfers would account for as much as 7.4% of annual expenditures. In addition Birdsall and Subramanian (2004) argue that in Chad resource financed cash transfer could increase the per capita income by 20%. Although these estimates do not subtract potential tax payments from their

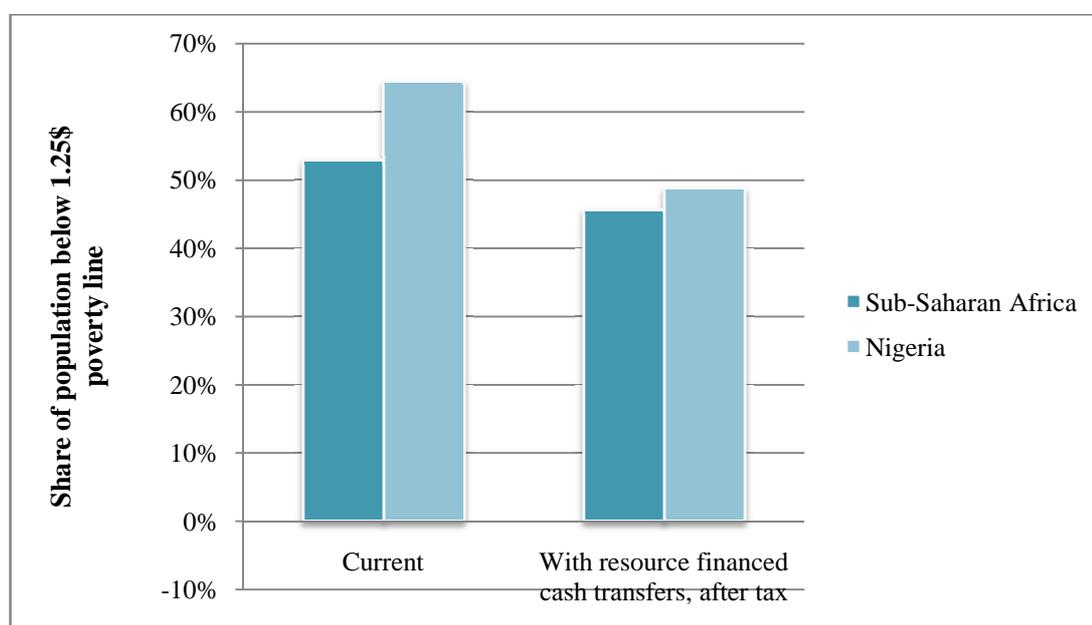
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<sup>35</sup> As Gelb and Decker (2011) and Moss (2011) illustrates, leakages up to incredible 99% have been documented in studies tracking the resource flows from government to local hospitals in Chad. In Ghana, which is relatively good performing country in terms of public sector management, leakages up to 50% in education and 80% in health have been found. Large-scale white elephant projects are yet another illustration of wasteful government spending in resource rich countries (Sandbu, 2006).

<sup>36</sup> All the estimations are based on 100% rent distribution schemes.

estimates, the direct distribution has in any case potential to contribute to income poverty reduction as underlined by all of the abovementioned authors.

Nevertheless, among the scholars dealing with this policy suggestion Segal (2011) provides perhaps the most comprehensive theoretical analysis of the potential immediate potential policy impacts on poverty reduction for 115 developing countries around the world. For Sub-Saharan Africa he finds out, that resource financed cash transfers accompanied with a total tax burden<sup>37</sup> equal to the share of resource rents in GDP<sup>38</sup>, would immediately decrease the number of people living below the \$1.25 threshold by 14% while the rate of extreme poverty would decrease by more than 7 percentage points (figure 7).



**Figure 7:** Immediate impact of the resource financed cash transfers on the share of population under the extreme poverty line (\$1.25/day) in Sub-Saharan Africa and Nigeria (Segal, 2011).

**Note:** Calculations based on 2005 poverty levels, average resource rents between 2002–2006 and total tax burden equal to the share of natural resources in GDP

Nevertheless in his calculations Segal also involves countries that have a very low share of natural resources in their GDP and therefore are not typical resource

<sup>37</sup> Segal (2011) does not include direct taxation of the cash transfers and assumes that governments will compensate for the lost income by collecting taxes elsewhere. Nevertheless since the way in which taxes are collected does not alter the total tax burden, results are equally valid for the model proposed in previous chapters that includes direct taxation of the cash transfers.

<sup>38</sup> The tax rate is determined perhaps based on an assumption that the higher the share of resource rents in GDP the higher the tax rate has to be to compensate for the lost income.

exporters on which the policy is aimed. It is therefore highly probable that in the resource dependent countries poverty will be reduced even more. To support this assumption Segal (2011) offers similar calculation for Nigeria where natural resource rents account for more than 51% of GDP. If the resource rents were directly distributed and the total tax burden would reach 51% the number of people living below the \$1.25 poverty line would be immediately reduced by 15.6 percentage points (figure 7, p.61). However, since it is not probable that the tax burden would be so high, poverty reduction is likely to be much higher and would therefore significantly contribute to the achievement of the first of the Millennium Development Goals not only in Nigeria but also in other resource rich African countries (Segal, 2011; Gelb and Majerowicz, 2011; Sala-i-Martin and Subramanian, 2003). Indeed the amount of resource rents to be distributed as well as the taxes levied would vary between the countries and therefore Segal's calculations should be regarded as indicative only. Nevertheless, they serve as a good illustration of potential direct positive effects on the income of the poorest people in several resource exporting countries in Sub-Saharan Africa.

Besides its immediate effects in form of poverty reduction resource financed cash transfers would also contribute to lower inequality. This effect is likely to manifest not only on the individual level in terms of income inequality but also on country level in terms of expenditures. In developing countries and especially in resource rich countries, governments transfers of resource rents in form of public expenditures and provision of public services is usually biased towards certain favoured regions – usually richer urban areas – and is therefore considerably unbalanced. Direct distribution of resource rents will not only induce the need for expansion of public services to more remote areas as has been argued, but distributing money among all citizens will be in general more equitable than existing patterns of government spending (Moss and Young, 2009; Moss, 2011).

On the individual level, considerable inequality can be found in low income developing countries in general and African resource exporters are not an exception (Gelb and Decker, 2011). The increase in income inequality in a resource rich countries has been documented for example in Nigeria which nowadays has the income Gini coefficient of 42.9 and where the top 2% of the population earns as much as the bottom 55%, while in 1970 they only earned as much as the bottom 17% (UNDP, 2011; Birdsall and Subramanian, 2004). Other resource rich dependent

African countries as well as those that will likely become resource exporters in the near future have similar Gini index as Nigeria (UNDP, 2011). In the case of the direct distribution of resource rents, equal amount of cash is transferred to every citizen. Since the same additional income will mean higher proportional increases for the poorest in comparison with the richest, inequality will decrease. At the same time, the lower the direct tax levied on the cash transfer the more egalitarian the distribution will be favouring the poorer over the richer (Sandbu, 2006). For illustration Segal (2011) calculated that for Nigeria, direct distribution of rents will potentially lower the value of the Gini coefficient to 19.1<sup>39</sup>. The redistributive potential of the direct distribution is therefore quite strong.

Transferring cash to poverty constrained individuals and subsequent increase in income may have a wide range of other potential positive socio-economic effects. These can be derived from other unconditional cash transfer programmes that have been put into practice around the world and in Africa as well. The evaluation of the South African Child Support Grant, which is an unconditional cash transfer programme in South Africa targeted at children, carried out by Agüero et al. (2007) confirms that significant improvements in child nutrition have been achieved due to increased income. By the same token Baird et al. (2011) carried out a cash transfer experiment in Malawi showing significant decrease in marriage of school aged girls as well as lower fertility among these girls. In addition, cash transfers were also positively correlated with lower school dropout rates. Higher investments in food, housing and education may be therefore considered as an investment in human capital that can have further positive effects on growth in the future (Segal, 2011). Empirical evidence from Ethiopia presented by Segal (2011) further suggests that cash transfer encourage entrepreneurship and investments into productive assets.

Positive economic effects may also be generated by the fact that the facilitation of cash transfer will require some kind of a banking system or a system of payments. Such system of payments may be helpful not only for the resource financed cash transfers but could again have positive spillovers to other sectors. Potential improvements in access to banking services and credit may be also vital for economic activities and beneficial for development of entrepreneurial activities (Moss and Young, 2009).

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<sup>39</sup> Calculations are based on a total tax burden of 51%. As has been argued the tax burden would in reality be probably lower and therefore, the redistributive effect might be even stronger.

There is yet another and rather implicit prospective positive outcome of the direct distribution of resource rents presented by Sala-i-Martin and Subramanian (2003) and Birdsall and Subramanian (2004). These authors argue that by giving resource rents to citizens, international creditors may be more eager to provide debt relief for the countries concerned. As has been argued resource dependent countries<sup>40</sup> are often indebted and governments seek to lift the debt burden. However, if the debt which is financed predominantly by resource rents as the main source of income in these countries is cancelled, governments will be free to use the funds that were previously dedicated to debt servicing for any purpose. Given the high leakages and corruption that accompany the public spending in these countries, it is improbable that these “savings” would be used for desirable developmental purposes. Therefore creditors may be rightfully reluctant to grant debt relief since they may fear that the “savings” from the debt relief will be wasted as are the resource rents. Distribution of rents in the form of cash transfers will imply, that the “savings” (as a part of the aggregate resource rents) will be transferred to citizens and therefore increase the motivation for debt cancellation.

#### **4.1.3 Common objections and possible problems**

While the resource financed cash transfers may indeed yield several positive outcomes both political as well as socioeconomic, it must be agreed that the implementation will not be without problems. Difficulties may come up both in political as well as in technical and economic regards and will have to be carefully considered in the process of the implementation. At the same time several scholars (for example Hjort, 2007; Gillies, 2010) have questioned the proposal of the resource financed cash transfers claiming that potential obstacles are so great that they could hardly be overcome. While some of the objections are indeed valid, others seem to be less supported statements. Review of the most common objections and related explanations follows.

One of the possible objections is that the policy would only be feasible in country with good governance. This assumption is certainly valid since there is no doubt that implementation of a programme which involves distribution of large sums of money will face several challenges including political manipulation,

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<sup>40</sup> Sala-i-Martin and Subramanian (2003) identify Nigeria as one of the examples.

corruption, mismanagement and the like, as is common in African resource exporting countries nowadays. It must be therefore no that implementation of the policy will certainly not be possible everywhere, especially in states with extreme corruption levels and instability as will be further explained in the following chapter (Devarajan et al., 2011). Nevertheless it must be equally noted that if implemented the policy of direct distribution of resource rents aims on improving governance by re-establishing the social contract and is therefore intended and has potential to ameliorate the management of public resources increase accountability or prevent resource rents from corrupting governments (Segal, 2011; Moss, 2011).

Another problem that is commonly pointed to is the fact that countries in Sub-Saharan Africa that are in need of better management of natural resources may lack capacity to implement the policy and reach all citizens. Although capacity problems, logistical and other constrains certainly exist in African resource exporting countries, there are some reasons for optimism especially because it is highly probable that people will be eager to actively cooperate (Birdsall and Subramanian, 2004). Therefore, distributing resource revenues should not be more difficult than implementing programmes to immunise children which many developing countries managed to carry out successfully (ibid.). Moreover, as has been argued technical advances could help counter some the logistical problems (Gelb and Decker, 2011). Gelb and Decker (2011, p.1) therefore argue that:

“[...] new technology has opened up an option that for many countries has only been a theoretical possibility up till now. The barriers to cash-transfers are no longer technical, but political.”

At the same time the increase in governments' capacity is very likely to be induced by the need to recover “lost” income through taxes which will require some bureaucratic apparatus.

Next, corruption is often regarded as an insuperable obstacle (Hjort, 2007). Here it must be noted that certain leakages will have to be accepted. However, as has been argued leakages could be minimised to a certain extent through disseminating information among citizenry and their active participation. Although it will not make corruption and leakages totally disappear Sala-i-Martin and Subramanian (2003) claim, that the situation will be much better in comparison with the status quo where citizens rely on getting their share of resource rents through public services whose

delivery is often accompanied with extreme leakages as argued previously. Leakages occurring in the resource financed cash transfers will imply that some beneficiaries will not get their part and hence it will be in their interest to seek redress.

With this relates another problem brought forward by Gillies (2010) who argues that citizens may know that they are being cheated but they still may not be able to do much to resist it. Indeed it must be acknowledged that information alone does not imply improvements in governance indicators and management. Citizens have to be equally able to seek redress if any discrepancies are found. Most commonly in democratic states, citizens could punish “bad managers” through ballot box by not voting for them anymore. This however may be problematic in some countries where elections are based on patronage or other forms of loyalty such as in Sierra Leone or Uganda (Nair, 2012; Gelb and Majerowicz, 2011). Second option would be to seek compensation through the judiciary system. As problematic as this possibility may seem Sala-i-Martin and Subramanian (2003) argue that it is quite realistic in Nigeria where the judiciary system is relatively well performing by African standards. Finally, Nair (2012) argues that pressure on governments could be exerted through civil society groups. His argument is empirically based on the fact that civil society groups were already relatively successful in influencing diamond rent allocation in Sierra Leone.

Another worry expressed in the literature is that when resource rents are distributed the income of governments will decline dramatically. However, since the ultimate goal of the policy is to force the government to find other sources of income (by taxing) this issue is often regarded as a benefit rather than a cost of the programme (Moss and Young, 2009). In a similar vein Birdsall and Subramanian (2004, p.87) argue that “good governance and strong institutions require that rising of public resources be costly”. Nevertheless some problems with recovering lost resources will certainly arise and it could be partially alleviated by the proposed programme design. Since taxing back some of the resource rents is an intrinsic part of the policy, there will be a substantial difference between gross transfers (before taxation) and net transfers (after the taxation). Thus governments will be immediately able to recover some of the transferred resources. Moreover as has been proposed, the proportion of the resource rents that are distributed could increase gradually providing some time for governments to adapt.

Closely related to this is another and one of the most prominent objections found in the literature, namely that resource rich developing countries in Sub-Saharan are in desperate need of physical infrastructure, schools, hospitals and the like and distribution resource rents to citizens will make development of infrastructure impossible. Such argumentation is indeed logical and few would probably argue that there is not a deficit of public facilities and physical infrastructure that is vital for development in these countries. However as Moss (2011, p. 10) argues “the mere existence of a need does not necessarily mean that the best use of new funds is to fill that deficiency”. To be specific, the experience with high leakages and extremely low efficiency of public investments summarised in previous chapters is likely to make such intentions problematic<sup>41</sup>. Since these imperfections in public resource management are unlikely to disappear overnight, channelling resource rents to the infrastructure building through governments’ budgets will most likely not solve the urgent needs for infrastructure and public facilities. And although some of the political leaders in future resource exporting countries<sup>42</sup> are eager to use resource rents for infrastructure building, the aim should be carefully reconsidered since as Gelb and Majerowicz (2011, p.20) argue

“[...] while every country thinks of itself as the exception to the rule, there are enough Nigerias and not nearly enough Botswanas to call for extreme caution.”

Further issue that critics are worried about is the potential impact of the cash transfer on the incentives to work. Several points can be made on this objection. First, Segal (2011) argues, that if people choose to work less it means that it makes them better off and indicates improvement in living conditions. Second, Gelb and Decker (2011) working on findings from South Africa and Namibia argue, that unconditional cash transfers may on the contrary help overcome obstacles to labour migration and increase mobility. Third, better nutrition associated with higher income is supposed to improve productivity (Segal, 2011). Finally, it is possible that cash transfers will represent a disincentive for the least productive members of the

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41 This includes high leakages in public service delivery as well as large-scale white elephant projects that are yet another illustration of wasteful government spending in resource rich countries (Moss, 2011; Gelb and Decker, 2011; Sandbu, 2006).

42 This is the case of Uganda for example where the leaders are awaiting inflow of oil rents in the near future and Sierra Leone where new revenue flows from iron ore and oil are eagerly awaited (Gelb and Majerowicz, 2011; Nair, 2012).

society, in other words those that work in low wage positions (ibid.). The higher the cash transfer, the higher the number of people in this group would be. Therefore in countries with considerable resource wealth and low population (such as for example Equatorial Guinea) the amount of transfers will have to be adjusted (perhaps by adjusting the tax rate) so that such disincentives are minimised. Gelb and Decker (2011) equally argue that in such cases measures may have to be taken to encourage labour market participation.

In a rather paternalistic manner it is sometimes argued, that distribution money in general and the resource rents in particular, among ordinary people would not be wise since they would headlong spend the money wastefully on consumption since they do not know what is good for them. Nonetheless neither this assumption is well-grounded. There is, as Moss (2011) argues not a smallest reason to think that ordinary people would know less what is good for them than some bureaucrats elsewhere. On the contrary, increased income provides freedom to decide how to lead one's life and possibility to improve it. Indeed as empirical evidence suggests, wasteful consumption is very probably not something that one should worry about in the case of the resource financed cash transfers. Goldsmith (2002, p.7) for example shows that in the case of the Alaskan PFD "there was not evidence of a widespread increase in 'wine, women, and song' as some had feared". As argued previously the resource financed cash transfers in hand of credit constrained individuals are more likely to be spent on personal necessities including investments in nutrition and education. And, most importantly, it must be realized that the potential outcomes of the policy must be compared with the status quo. That means, in the words of Sandbu (2006, p. 1162) that "what matters is not whether individuals would behave wastefully, but whether they would behave more wastefully than the government."

Transferring resource rents to citizens may, and probably will, cause inflation. In this case again, one has to compare the current situation with the one that would occur after the implementation of the resource financed cash transfers. As Moss (2011) argues, inflation is very likely to be similar or even higher if the rents were left in the hands of governments. If inflation was to be curbed it the rents would have to be deposited in an offshore fund. However, given the negative experience with such funds in Africa there is little reason to think that the government spending would produce lower inflation than personal spending. In any

of the cases, macroeconomic measures will have to be introduced to reduce the inflationary pressures (ibid).

Last objection to analyse and probably the most concerning one is the presence of political resistance in resource rich countries. Powerful and deeply entrenched rent-seeking groups and vested interests present in resource rich African countries may render the policy politically infeasible. The fact is that unless political will exists, the policy cannot be implemented. Hence, it must be acknowledged that the policy will certainly not be feasible in every African resource rich country. Selection of suitable candidates and political feasibility will be the subject of the following chapter.

## **4.2 Selection of potential candidates**

### **4.2.1 Political feasibility**

Although there are numerous resource rich countries<sup>43</sup> from different regions that face or are likely to face natural resource curse in the future, Sub-Saharan Africa as has been argued offers the highest concentration of resource rent related problems. From global perspective therefore, there is no doubt that Africa needs something that would get its resource exporters out of a tight corner and direct distribution of resource rents in the form of proposed cash transfers offer a promising alternative. There are several reasons for such argumentation. Besides high concentration of resource dependent countries and lack of accountability, countries in this region have the highest percentage of people living in extreme poverty (Segal, 2011). Moreover, measures should be taken in countries that have become or will become new resource exporters in the future to keep negative effects of resource rents to a minimum. There is therefore little wonder that the research on direct distribution of resource rents through cash transfers focuses, from the global perspective, predominantly on African continent (for example Moss and Young, 2009; Nair, 2012; Sala-i-Martin and Subramanian, 2003; Goldman, 2011 and others).

On country level, the general framework of the resource financed cash transfers could in theory be applied in any resource rich country in Africa. Nonetheless for

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<sup>43</sup> Moss (2011) for example considers East Timor as potential candidate for implementation of resource financed cash transfers while Birdsall and Subramanian (2004) and West (2011) consider Iraq as a suitable candidate.

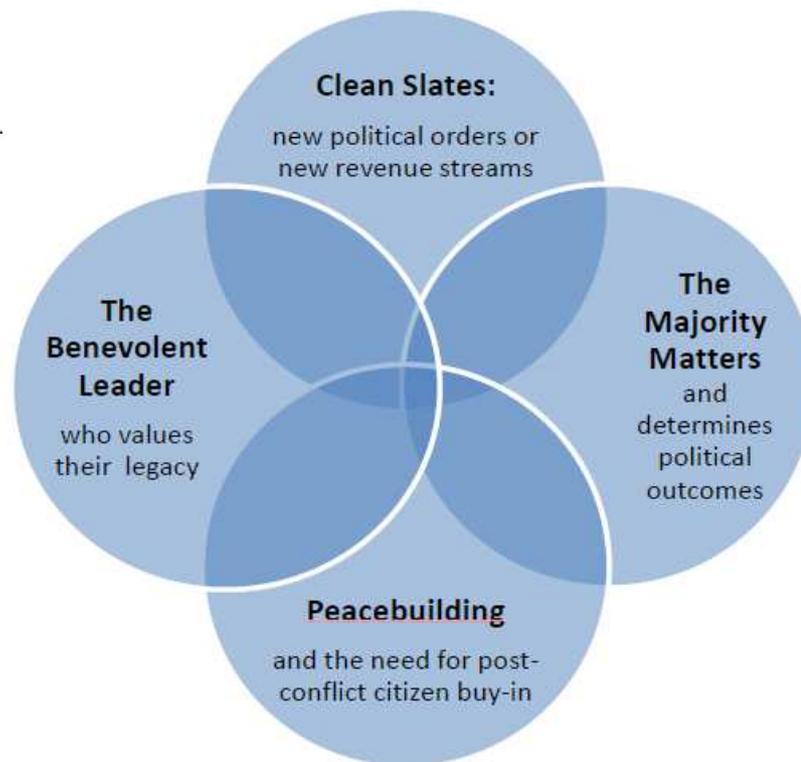
different reasons the concept would be more feasible in some countries than in other. Although there are some technical issues that have been analysed in previous chapters, the challenges are predominantly political. Entrusting easy income (i.e. the resource rents) in the hands of people is likely to be politically tough. Identifying suitable countries for policy implementation is therefore also very common subject of analyses.

Gillies (2010) provides one of the most comprehensive analyses of the policy in respect to its political feasibility in the context of resource rich countries. Her examinations are based on an assumption that in resource rich countries two characteristics of political elites are prevalent. First, centralisation of resources rents and power in hands of a small number of top country officials who control the decision-making is common. Second, as previously argued, through rent-seeking and patronage the leaders allocate the resource rents they control so that to improve their position in power. Since they effortlessly enjoy steady inflow of unearned resource rents they are not motivated to serve their citizens and favour their political interests over economic need of the country they govern. Direct distribution of resource rents to citizens in the form of cash transfers turns the rent distribution channels around. Summarized in the words of Gillies (2010, p.3):

“The greatest ‘winner’ of direct distribution is the citizenry [...]. The greatest ‘loser’ would be those rent-seeking elites who would otherwise receive the resources.”

In other words the resource financed cash transfers “include those parts of the population that are left in misery by the natural resource curse” (Sandbu, 2006, p.1164).

Nonetheless, since under normal circumstances in resource rich countries rent seekers are favoured over citizens, direct rent distribution may not be welcome. The likelihood of embracing the policy of the resource financed cash transfers “increases when the leader, as the dominant actor in a resource rich state, places greater value on the winner [citizenry] than the loser [rent seekers]” (Gillies, 2010, p.3). Although in some countries this situation may be elusive, several scenarios have been proposed in which this situation may occur. The most frequent of them are summarised in figure 8. These scenarios are not mutually exclusive and can coexist at one place at a time (ibid.).



**Figure 8:** Scenarios of political feasibility of the resource financed cash transfers (Gillies, 2010)

Conditions for implementation of the resource financed cash transfers may be for example favourable in what Gillies (2010) refers to as “clean states”. In these countries, rent-seeking groups that could theoretically thwart the implementation efforts are only potential and are not yet deeply entrenched and therefore easier to overcome (ibid.). Two types of political environment may be present in the so called clean states. First, countries with new political order may be suitable for the implementation. These are either post-conflict or post-revolution countries in which old political arrangements have been dissolved. Direct distribution of resource rents may be therefore considered in the process of building new political and socio-economic order (Sandbu, 2006). Such countries are mostly situated outside Africa with Iraq being a textbook example of this type of state often cited in the literature (for example Birdsall and Subramanian, 2004; West, 2010). Sub-Saharan Africa does not offer many examples of this kind. Although for example South Sudan might be considered appropriate in this regard, implementation of the policy in this country may be elusive at least because of technical and capacity reasons.

Second group of countries considered as politically “clean” are new resource exporters (Devarajan et al., 2011; Moss, 2011). Unlike in the first case, Sub-Saharan

Africa has a number of representatives in this group including Ghana, Uganda and Liberia (Moss and Young, 2009; Nair, 2012). More recently oil reserves have been found in Kenya and the fourth largest natural gas reserves in the world have been discovered in Mozambique (BBC, 2011; BBC, 2012). These countries can be considered suitable for two major reasons. Along with the non-existence of well established rent-seeking groups it is the need to help prevent these vulnerable countries from being “cursed” by natural resources. It would therefore be appropriate to set up the resource finance cash transfers before resource rents start to flow at full. Although some governments may have other plans with the revenues such as infrastructure building, these obstacles are much easier to overcome than well entrenched rent-seeking groups in other countries (Sandbu, 2006). The list of new oil and gas producers in Sub-Saharan Africa is provided in table 2.

Country	Resource	Discovery Year	Expected extraction	Potential quantity
Ghana	Oil	2007	2011	0.6-1.8 billion barrels
Sierra Leone	Oil, iron ore	2009	To be defined	450 mil barrels of oil, 4,7 billion tons of iron
South Sudan	Oil	1978	Independence 2011	3.75 billion barrels
Uganda	Oil	2006	2011	1.2 billion barrels
Mozambique	Natural gas	2011	2018	1047 trillion cubic metres
Kenya	Oil	2012	To be defined	2.5 billion barrels estimated

**Table 2:** New resource exporters and/or significant new resource discoveries

**Sources:** OECD (2012), Moss (2011), Nair (2012), Businessweek (2012)

**Notes:** Although the reserves of oil in South Sudan are not new, due to its independence granted in 2011 the country may be regarded as a new oil producer.

Environment suitable for implementation of the resource financed cash transfers can be also found in countries where, as the model presented by Gillies (2010) shows, the majority matters. This situation may occur in countries with competitive democracy, where parties can offer this appealing policy to gain political support (ibid.). Although it is true that one would count well performing

democracies in Africa on the fingers of one hand, there are some promising examples as for example Ghana. In a similar vein, direct distribution may be used as a strong populist argument to gain support against contemporary political representation. Since the direct distribution of resource rents may be interpreted as giving money to the poor it is likely to be very popular (Sala-i-Martin and Subramanian, 2003; Sandbu, 2006). The resource financed cash transfers may be a realistic option even if competitive democracy as such is not present. This could be the case in countries, where leaders that depend on the support of broad constituency and therefore they may consider direct distribution as a policy that could appeal to his supporters (Gillies, 2010).

The resource financed cash transfers may further be used in post-conflict states as a part of peace-building process. Because of its redistributive character, the cash transfers are likely to reduce further tendencies to fight for resource rents (Gillies, 2010). Indeed, different forms cash transfers have been used in peace-building in several countries outside Africa including Afghanistan, Nepal as well as in some African states such as Somalia and Sierra Leone (ibid.).

Finally Gillies argues, that resource financed cash transfers could be an option even in countries that have so far manifested wide range of symptoms related to bad governance. As argued, the leaders in autocratic and predatory states often have, along with personal interest related to their position in power, wide range of other perhaps also developmental visions. Hence even in autocratic states the leaders, which Gillies calls as “benevolent”, could choose to implement the resource financed cash transfers to gain legitimacy and popularity provided that it does not threaten their agenda and perhaps position in power.

In addition to the presented political circumstances in which the implementation of resource financed cash transfer becomes possible, Devarajan et al. (2011) argue that certain initial level of stability and transparency and institutions is necessary as well. In other words, in countries with very high levels of corruption, nonexistent institutions and extremely weak governance direct distribution of resource rents would be most desirable and probably most transforming on one hand, while it would be extremely difficult to implement because of potentially very high leakages and inability to technically put the policy into practice (Gillies, 2010). By the same token, countries that show relatively better figures in respect to institutions and governance are likely to be good candidates.

#### **4.2.2 Country case considerations**

From the above analysis it is clear that the policy of the resource financed cash transfers will not be universally feasible in all resource rich countries across Sub-Saharan Africa. While some general criteria for feasibility have been identified, analyses of the policy feasibility for individual countries can be only rarely found in the literature, perhaps due to the fact that this policy proposal is relatively new. Nevertheless recent discoveries of natural resources in several African countries have provided further motivation for scholars to consider the implementation of the policy in these countries. Indeed there are several countries in which the policy could be an option both new and traditional resource exporters. For the limited space and lack of relevant analyses for other countries respectively, two cases will be considered in more detail.

First, and probably the most prominently analysed in the literature is Ghana – one of the new oil exporting countries and a relative success stories in terms of governance in Africa. Further, Sierra Leone which is not a new resource exporter in the true sense will be considered.

##### ***4.2.2.1 Ghana***

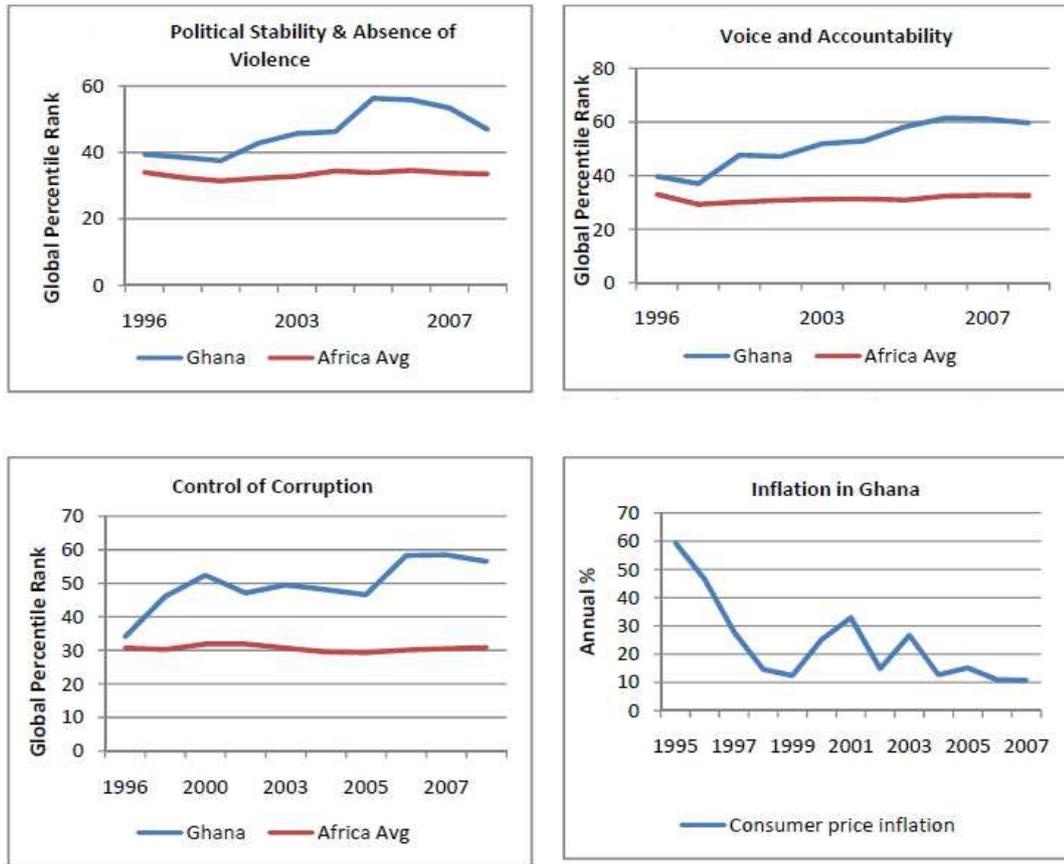
Among scholars Ghana is perhaps the most favourite country to choose for the implementation of resource financed cash transfers. Indeed there are good reasons for that, since the country fulfils a number of the aforementioned criteria at a time which has no parallel in Africa. As figure 9 (p.75) shows, Ghana fares much better than African average in a number of relevant indicators. Besides much better scores in peace and stability indicators, the quality of democracy in terms of voice and accountability is also quite high, which is an important plus (Moss and Young, 2009).

Ghana has also been one from the handful of African states classified as free in terms of political rights and civil liberties (Freedom House, 2012). This is a very significant advantage since through democratic institutions citizens may express their interest or, alternatively, “punish” the politicians who do not manage public

resources well (Gillies, 2010). In addition to that, Ghana's record in corruption perception index is quite remarkable at about the same level as Italy (Transparency International, 2011). Also the macroeconomic management of the country is not what one would expect from a typical African country which the government has proven by curbing inflation in recent years as seen in figure 9 (p.75). So far, one would hardly argue that Ghana is not on the right way in terms of development and would need some rapid policy changes.

Nevertheless after the 2009 oil discovery Ghana joined the ranks of new oil producers in Africa. As soon as in 2015, the oil rents are expected to constitute as much as 34% of total government revenues. While potential inflow of new oil revenues certainly provides some reasons for optimism, infamous experience of other resource rich countries in Sub-Saharan Africa suggests that this amount of unearned income could equally corrode governance and reverse all of the achievements which Ghana can be proud of.

The government of Ghana has ever since the oil discovery been receiving a number of advices to deal with the oil wealth (Moss and Young, 2009). These recommendations are rather conventional including creation of an offshore natural resource fund as well as using the rents for financing infrastructure. Since as has been argued creation of fund will not lead to creation of interest groups that would monitor how the money is spent and financing infrastructure usually leads to huge leakages. Implementation of the resource financed cash transfers is therefore regarded as much more suitable option. Favourable political and institutional climate may at the same time significantly facilitate the implementation as well as running of the programme.



**Figure 9:** Selected governance and microeconomic indicators in Ghana, comparison with the African average (Moss and Young, 2009).

#### 4.2.2.1 Sierra Leone

Based on the previous political feasibility analysis Sierra Leone is another country that could be considered as suitable candidate. Nevertheless, despite it has been a while since the fighting's in this country were ceased, potential selection of Sierra Leone for the implementation of the policy of the resource financed cash transfers may be at the same time surprising, given the political instability and violence that the conflict caused. Nevertheless, according to Nair (2012) despite enormous socioeconomic and political problems after the war, significant improvements in stability as well as governance indicators have been achieved in recent years which could be beneficial for implementation of the policy. In this regard the country could be partially considered as a clean state. Achievements in building multi-party

democratic system and holding free election however cannot be overestimated and it must be noted that the democracy is still in infancy (ibid).

The country's portfolio of natural resource exports is nowadays dominated by diamonds and titanium ore (World Bank, 2011). Therefore, Sierra Leone has some experience with extraction of natural resources and some vested interest may be present as has been already argued in the previous chapters. The policy of the resource financed cash transfers however, has been proposed in reaction to the discovery of new immense iron ore deposits and forthcoming oil extraction (Nair, 2012). The increase in iron ore production alone has a potential to double the country's GDP in the three to five years becoming dominant export commodity of the country. Moreover the value of new oil reserves that have been discovered in 2009 and 2010 could be equivalent to that of the iron ore reserves (ibid.). Given the amount and the value of the new natural resource discoveries as well as its potential impact on country's economy, Sierra Leone could in a certain way also considered as a new resource producer.

Although the new discoveries represent a great potential in terms of government income, the greatest challenge, as in other resource rich countries, will be to translate the revenues into positive socioeconomic outcomes in a country with GDP per capita of 374\$ and 70% of the population living below \$1.25 poverty line (World Bank, 2012a; Nair, 2012). Indeed the resource financed cash transfer could provide means to improve living conditions as well as the governance in this context. There are nonetheless several constrains that could thwart the implementation efforts.

First, as Nair (2012) argues, the country is as well as other post-conflict and/or low income African countries, in desperate need of infrastructure. Channelling resource rents to infrastructure building would, as well as in the case of Ghana, desirable for the reason of low efficiency of government spending. Nevertheless infrastructure building is a popular issue that resonates among the citizenry and is often subjects of political agendas among the political parties in the country. This could therefore be regarded as a potential problem that disqualifies the implementation of the resource financed cash transfers. And yet as argued by Gillies (2010) as well as Sandbu (2006) there are reasons to think that, if brought forward, handing cash to citizens could be even more popular idea. As Nair (2012) further argues, the opportunity for distribution of rents in the form of cash transfers exists

especially for the forthcoming oil revenues since the legislative rules concerning its extraction are yet in the pipeline.

Second, some problems may arise because of the weak tax administration (Nair, 2012). As for the former, there are reasons for some optimism in this regard. In 2010 despite initial uncertainties, the government has managed to successfully implement value added tax collection which now generated more income than was initially expected. Moreover building cash administration could be initially financed from the resource rents and perhaps externally assisted (ibid.).

Finally Nair (2012) argues that problems regarding the lack of skilled personnel will have to be addressed in order to facilitate not only the implementation of the programme as such but also the operation itself which may not be an easy task. Nevertheless there have been some cash transfer programmes run by the government of Sierra Leone. Although these were much smaller in scale, they may indicate that with some external assistance the challenge may not be unbeatable.

## 5. Conclusion

Despite enormous potential that the income from the sale of natural resources represents, resource rich developing countries apart from rare success stories are still plagued by high corruption, rent-seeking, low economic growth, extreme poverty, indebtedness and conflicts. The problems associated with so called natural resource curse are especially concentrated in Sub-Saharan Africa where large number of countries is dependent on natural resource exports. Several economic explanations exist for how the natural resource curse emerges the most prominent being the well known phenomenon called the Dutch Disease.

The primary cause of the curse however, seems to lie in political economy. The inflow of unearned resource rents decreases the need of governments to generate income by taxing and thus decreases their motivation to provide public services. On the other hand, citizens, because they are not taxed are not motivated to scrutinise the governments' management of public finances leading to the corrosion of so called fiscal contract.

Conventional policies to manage the resource wealth that are well established in the successful countries from all over the world therefore, despite significant external support, do not seem to work in African resource dependent countries since they fail to create the domestic demand for sound management of public revenues.

The policy of the direct distribution of resource rents through unconditional and universal cash transfers provides an opportunity to alleviate the resource curse. By taking resource rents from governments' budgets and distributing them among citizens, governments will be forced to increase their income by taxation. This will ultimately lead to re-establishment the fiscal contract between citizens and governments and increasing the citizens' stake in natural resource management.

Along with potential positive impacts on governance and management of resource rents, direct distribution will imply immediate increase in household income and more equitable income distribution. Further as experience from other unconditional cash transfers suggest this could in turn lead to improvements in nutrition, health school attendance and family planning among the poorest members of the society.

The implementation of the resource financed cash transfers is likely to bring several technical challenges which will have to be, at least partially, countered by

the policy design. To maintain certain level of government part of the cash transfers would be immediately taxed back. To reduce potential leakages, it must be ensured that citizens have access to information about governments' income. To lower transaction costs and tackle technical challenges modern technologies such as mobile payments may be considered for use along with other means.

More importantly the policy is very likely to face significant political challenges especially in respect to the political feasibility. Therefore suitable candidate countries have to be thoroughly selected especially in respect to the political will to implement the policy. Thus one of the prerequisites for successful implementation is certain level of political stability, transparency and perhaps democracy. Moreover, the policy is more likely to be politically feasible in countries where vested interest and rent-seeking groups are not yet deeply entrenched such as new resource exporters in which the policy may prevent the curse from manifesting. Besides, because of its potential popularity among citizens, it may become a part of political agenda in countries with certain level of democracy as well.

Despite its potentials the policy of the resource financed cash transfers is neither intended to be a panacea for all problems of African resource exporting countries nor a universal remedy for natural resource curse. There is no doubt that challenges will arise in the implementation stage as well as during the operation of the programme. The policy however must be considered against the current situation in resource rich countries and not against an unattainable ideal. Is such comparison is made the policy of the resource financed cash transfers appears to be promising alternative.

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