UNRISD United Nations Research Institute for Social Development

CONFERENCE NEWS

Social Policy in Mineral-Rich Countries

Report of the UNRISD Workshop
24-25 April 2008, Geneva

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Introduction

Why do some mineral-rich countries channel their resources into sustainable economic and social policies, while others do not? What are the factors that impede resource-rich countries in the South from investing more of their wealth in social development? Can boosting mineral rents open fiscal space for transformative social policies in a context that is also conducive to democracy, social inclusion and economic development? These are some of the questions guiding research under a project at the United Nations Research Institute for Social Development (UNRISD), *Financing Social Policy in Mineral-Rich Countries*, which is part of the second stage of a broader inquiry, initiated in 2006, *Financing Social Policy* (see UNRISD Conference News No. 18, 2007). The umbrella project, funded by the Ford Foundation, explores the developmental impact associated with specific financing techniques and revenue resources such as taxation, social insurance contributions, social and pension funds, remittances, aid and the topic of this issue of Conference News: mineral rents.

In 2007, UNRISD commissioned eight papers on the theme of financing social policy through mineral rents, which included four conceptual papers and four case studies on Chile, Indonesia, Nigeria and Norway. These papers were presented during a two-day workshop in Geneva on 24–25 April 2008. The workshop brought together commissioned authors as well as academics and experts from the United Nations, including staff from the International Labour Organization (ILO) and the United Nations Conference on Trade and Development (UNCTAD).

In his opening remarks, UNRISD Director Thandika Mkandawire welcomed participants and introduced the UNRISD research programme on Social Policy and Development. This programme is built on the recognition that social policy has multiple roles that go beyond social protection and poverty reduction, simultaneously affecting production, redistribution and gender as well as state-society relations. He explained that the key role social policy plays in terms of economic development, social cohesion and democratization has been shown in UNRISD research on late-industrializing Nordic, East Asian and Latin American countries). In this research it also became clear that the financing question had to be tackled successfully in order to build sustainable development models. Finally, Mkandawire said, he hoped that the workshop would provide an opportunity to share and learn from each other's experiences—across countries and across disciplines—on development, welfare regimes and democratization.

Katja Hujo followed with an overview of the research project. She noted that in a context of globalization, states' capacities to raise revenues had been undermined by processes like trade and capital account liberalization, labour market problems like unemployment and increasing informality, income and asset concentration, and persistent debt problems. At the same time, there was a growing need for social policies in order to compensate for the social costs produced by market volatility and economic crises, to provide income support to increased numbers of unemployed and excluded people, and to manage processes of demographic and social change. At the time the conference took place, the global economy was not yet showing the dramatic signs of the economic and financial crisis, as it was by late 2008, and the international context still presented some positive features such as low interest and inflation rates and high commodity prices, which Hujo characterized as windows of opportunity for developing countries. Describing the links between mineral wealth and social development, she referred to the issue of human resources; the enclave nature of the mining industry and regional income and wage disparities; concerns about fragmentation of national social systems through the creation of privileged schemes for mining employees; problems of armed conflict financed by mineral rents; the relationship between the mining industry and migration; and effects of the sector and related policies on gender and family structures. Hujo concluded by outlining the main research questions guiding the project, which focus on:

- the developmental and distributional impacts of mineral rents and the ways mineral rents affect production, reproduction, protection and re-distribution;
- the link between resource abundance and key social indicators in different countries;
- politics and political regimes that are engendered by mineral wealth, and the implications for social development and social policy;
- promising policies to tackle the macroeconomic challenges associated with mineral wealth, as well as preconditions to make these policies work; and
- policies that could create synergies between social and economic policy, and the possibility of trade-offs between the two.

Following this introductory session, participants were invited to make some initial comments on the broader research framework. This discussion confirmed that direct interaction between mineral-rich countries can make an important contribution to "policy learning" through knowledge sharing about successful development experiences in these contexts.

Different actors like the World Bank, the Norwegian government and international non-governmental organizations (NGOs) are already active in this area. Participants remarked upon the need not only to learn from successful countries, but also to promote a critical stance on one-size-fits-all policies and to move beyond standardized solutions. Especially with regard to newcomers like Mauritania or Ghana, which have recently discovered natural resource wealth, it was deemed useful to engage in ex ante analysis in order to design institutions with the capacity to manage revenues well. Furthermore, participants suggested that the focus on the so-called resource curse, a supposed negative relationship between natural resource abundance and economic growth, had resulted in deterministic views on the development implications of mineral wealth and produced confusion among developing countries—leading, for example, to the paradoxical conclusion that a country would do better to avoid finding oil and other natural resources in order to grow. The real challenge for mineral-rich countries, it was emphasized, is to develop the capacity to absorb funds from the mineral sector and allocate them to productive and social investments. Unfortunately, this capacity and the institutions that traditionally served to carry out such functions were weakened, and even dismantled, during the neoliberal adjustment era.

Session 1: Economic Challenges and Potential in Mineral-Rich Countries

The first thematic session of the workshop dealt with economic challenges, growth performance and economic policy responses in mineral-rich countries. Although the challenges associated with mineral rents are well known and common to all countries, economic policy responses vary considerably. The range of

mechanisms for coping with the threat of Dutch disease,[1] as well as different approaches to manage and allocate revenue streams from minerals, generate different outcomes. The two papers presented in this session show that both national and international factors influence the economic performance of mineral-rich countries. However, they place a stronger emphasis on the significance of internal variables—institutions and governance, investment in human capital and sound macroeconomic policies.

Samuel Asfaha gave the first presentation of the session, on "Economic Policy in Mineral-Rich Countries". According to Asfaha, resource-rich countries have to deal with the issues of volatility and long-term sustainability of prices and revenues. In addition, various problems have been identified in mineral-rich countries: the already mentioned resource-curse literature establishes a negative correlation between mineral wealth and economic growth as well as standards of living and democracy; many analysts also see fertile ground for social conflict, poor economic policy management (which explains a tendency to fall into the Dutch disease trap), and heavy borrowing. Additionally, some of these countries are victims of overconfidence with regard to the sustainability and magnitude of flows, which leads to a "rent-seeking mentality", in the sense that the development of productive activities is increasingly neglected. Policies end up being influenced by politically connected interest groups at the expense of entrepreneurialism, which subsequently turns policy makers away from social interests.

Asfaha argued that the effect of natural wealth on development depends on how it is managed. To illustrate this, he suggested two extreme scenarios. In the first, the government spends all the proceeds of a mineral boom on consumption, leading to real exchange rate appreciation and Dutch disease symptoms, which further fuel consumption, increase production of non-traded goods and cause a real contraction in the non-resource tradable sector. In the second, the government invests the windfall proceeds of the boom in productivity-augmenting projects, with which a country can produce more of both traded and non-traded goods. The second scenario is associated with growth and increased productivity, which reflects an escape from Dutch disease.

Asfaha explained that in the less successful empirical cases, most expenditure was in the form of over-expanded public sector employment; wages and transfers; and subsidies on food, fertilizers and petroleum. Some ventures could even be characterized as "white elephants" in which political prestige was the sole driving force or in which funds were used to complete obsolete projects or to prop up inefficient enterprises with few or no linkages to the productive sectors of the economy.

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According to Asfaha, the prudent approach is to accumulate savings during booms for sustainable financing of investment projects during busts. This requires fiscal policy to be countercyclical in order to avoid situations where revenue volatility is translated into expenditure volatility. He cited the cases of Mexico and Nigeria to illustrate the effects of pro-cyclical policies, where aggressive expenditure of windfall oil revenue was paralleled by a significant increase in external debt. This stifled growth beyond what would have resulted solely from a fall in commodity prices. Asfaha then demonstrated that the resource curse can be reversed with effective policy management. Countries like Botswana, Indonesia and Norway accumulated huge reserves *and* maintained macroeconomic stability. For these countries, the return on assets invested represents a significant source of revenue, more or less equal in importance to customs and excise revenues. However, Asfaha cautioned, when funds are readily available and

[1] Dutch disease refers to rising inflation rates and exchange rate appreciation produced by capital inflows. As a consequence, domestic production becomes less competitive in world markets, adversely affecting the country's trade balance. In the longer term, investors tend to shift their resources into the non-tradable sector.

known to be available, exceptionally strong institutions are required in order to maintain fiscal discipline.

Rent-seeking behaviour, incited by the considerable returns to those who are able to capture mineral rents, may lead to a concentration of economic and political power in the hands of elites, and may breed corruption. A reduction of efficiency and social equity as a result of rent-seeking behaviour has been reported for oil-rich countries like Mexico, Nigeria and Venezuela. Policies tend to benefit groups that policy makers, or their associates, are linked to. In these cases, policies are guided by short time horizons that prioritize the government's short-term political gains, often at the expense of long-term economic development. This is a problem that arises if elite interests are not linked with the interests of production-based groups, as they are in more successful cases such as Botswana.

Asfaha ended his presentation by pointing out some recent international policy initiatives (such as the international transparency initiative, or the World Bank's engagement in Chad) that aim at greater transparency in the management of mineral revenues. He expressed doubts that these initiatives alone would be sufficient to alter the political and economic incentives faced by governments in mineral-rich countries.

The second thematic paper presented in this session was "Development and Growth in Mineral-Rich Countries", by Thorvaldur Gylfason. He presented empirical evidence based on newly published data sets

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that shed light on the general hypothesis that natural resource *dependence* may hurt economic growth in developing countries, although resource *abundance* in advanced countries seems to be beneficial. Gylfason identified economic and political diversification, investments in social and human capital, as well as democracy and good institutions as important factors to explain and enhance positive growth and development performance.

According to Gylfason, social development and economic growth are closely intertwined. When social indicators of life expectancy, fertility and literacy have high levels, this conveys a clear and consistent picture of progress, and sometimes a more accurate picture than more commonly used economic indicators. However, apart from education and health care, social policy issues have been absent from much of the recent academic debate on economic growth.

Gylfason then summarized debates surrounding the relationship of economic growth and income distribution. One well-established hypothesis is that income inequality is a catalyst for real capital accumulation and growth, given the large numbers of rich people inclined to save. In this line of reasoning, income redistribution would reduce savings, slow the accumulation of capital, and thus reduce investment and growth. Another hypothesis suggests that income inequality endangers social cohesion, political stability and peace, thus spoiling the investment claim; in this view, it also triggers counterproductive demands for redistribution, reducing efficiency and growth. Even though the theoretical literature behind this is ambiguous and inconclusive, Gylfason claims that there are strong a priori and empirical grounds for believing that social expenditure—and social policies more generally—*do* matter for economic growth. Specifically, he said, saving and investment, education, training, health care and family planning, absence of corruption, democracy and macroeconomic stability are important factors for growth.

Gylfason went on to explain how natural capital influences other kinds of capital or their determinants. First, abundant natural resources may blunt private and public incentives to save and invest, slowing economic growth. Second, natural capital may crowd out human capital by weakening private and public incentives to give a high priority to education. And third, mineral-rich countries tend to be marred by rent seeking on the part of producers who divert resources from more socially fruitful economic activities; as mentioned in the previous

presentation, this may lead to a concentration of economic and political power.

Using recent data for 164 countries from the World Bank, UNCTAD and Transparency International, Gylfason then presented the results of various regression models. His first finding was that school life expectancy[2] is inversely related across countries to natural resource dependence as represented by the share of natural capital in total wealth. This would indicate that natural capital tends to crowd out human capital. The second finding was that corruption perception is positively correlated across countries with the share of natural capital in total wealth but inversely correlated with the growth of per capita GDP. Democracy was found to be inversely correlated with the share of natural capital in total wealth across countries, while growth was positively correlated with democracy. These results would support the conclusion that natural capital tends to crowd out social capital and hurt growth. The third finding was a close positive cross-country correlation between school life expectancy and democracy, with each additional year of schooling going along with an increase in democracy by one point, supporting the argument that human capital and social capital go hand in hand. The fourth result highlighted by Gylfason was that different aspects of social capital are likely to interact and to reinforce each other, as indicated by the inverse correlation between democracy and the perception of corruption.

Gylfason went on to identify two ways in which natural capital influences economic growth. On the one hand, an increase in the share of natural capital in total wealth reduces economic growth. On the other hand, an increase in natural capital per person stimulates growth. It should be noted that an increase in the natural capital share tends to reduce growth in developing countries, but may increase growth in industrialized countries.

In concluding his presentation, Gylfason summarized the main arguments of his paper. First, he said, diversification is good for growth, as it allows a country to move away from excessive reliance on natural resources and from narrowly based political elites towards full-fledged democracy. Second, social policy and human capital (including social insurance, education and health care) play a positive role in enhancing growth. Third, Gylfason argued, a judicious use of natural resources requires good institutions, which includes democracy. Finally, he concluded, adequate strategies to turn natural capital sustainably into human and social capital are yet to be developed.

Discussion

The follow-up discussion was chaired by Janvier Nkurunziza, with Katja Hujo and Albert Berry as discussants. One of the main issues addressed by Hujo with regard to the Asfaha paper had to do with the economic policy needed to combat Dutch disease. She suggested discussing this question in the wider context of the literature on developmental impacts of capital inflows: one precondition to avoid destabilizing effects of capital inflows is to have relatively well-functioning institutions to conduct fiscal, monetary or social policy to respond to these flows. For example, reducing the supply of domestic currency through monetary sterilization is difficult without a central bank managing a sufficiently large monetary base. She then referred to the advantages and disadvantages of devaluating the exchange rate or of exporting capital (for example through reserve accumulation) in order to combat Dutch disease. There are valid reasons why governments are reluctant to devalue, as it is not easy to avoid devaluation-debt/revaluation-inflation cycles, potentially leading to bankruptcies in the productive and financial sectors, dollarization and capital flight. With regard to reserve accumulation or investment of funds abroad, she held that these measures (which aim at stabilization) could conflict with the need to channel funds into social expenditure or other investments. Those different objectives had to be carefully balanced. And lastly, she noted how uncomplicated it was to find fault with a policy *after* it has been implemented. If we look at countries that were praised for their economic model but then fell into crisis, and others that were criticized for their unorthodox approach but nevertheless performed well, can we still claim that what the mainstream calls "good policies" provide the sufficient conditions for growth and development?

[2] School life expectancy is the total number of years of schooling a child can expect to receive, assuming that the probability of his or her being enrolled in school at any particular future age is equal to the current enrolment ratio at that age.

Nkurunziza raised the need for a dynamic analysis. Nigeria, he explained, had repaid most of its external debt because of the recent oil boom, and it had also successfully restructured its banking sector. It would be proper to study such positive signs in contemporary Nigeria and analyse what had prevented the country from showing such signs earlier. He confirmed the opportunity costs of avoiding Dutch disease through reserve accumulation and suggested that greater attention be paid to issues such as capital flight, crowding-out of other revenues by mineral rents and the external dimension of policy making in mineral-rich countries as exemplified by the World Bank–Chad cooperation.

Mkandawire commented that it was necessary to analyse the forces that incite governments to use fiscal surpluses in particular ways. The strength or weakness of civil society or trade unions, as well as other contextual factors, are important to explain why some governments spend and others do not. With regard to the discussion on the concepts of rentier state versus rent-seeking, he recalled that the term rentier state referred to the revenue base of a country, whereas rent-seeking described the behaviour of capturing rents.

In his comments on the presentation by Gylfason, Berry stated that the challenge of effective social policies in mineral-rich countries was indeed a key challenge of our times. Indeed, export booms invite spending on non-tradables, but not necessarily on health and education. While underlining the need to incorporate social policy concerns early on into development strategies of mineral-rich countries, he recognized the difficulties in choosing the right timing and focus of such policies, especially with regard to investments in human resources, as uncertain and changing comparative advantages and patterns of diversification in these countries made planning a challenging task.

With regard to the argument that smaller family size allows for higher per capita investments in education, Berry mentioned the possibility of reverse causation, where higher per capita income due to faster growth slows population growth. In addition, he argued, the strength of the argument regarding the relationship between family size and investment in education needs to be reconsidered both in light of the social return on education and the willingness as well as capacity of the state to invest in children from low-income families, and the actual educational spending of small families. A different transmission channel from mineral rents toward low educational investments could be inequality, as mineral rents are associated with income inequality which in turn is correlated with less education. Finally, Berry emphasized the importance of case studies in order to approach the institutional question with regard to legal, economic and social policy issues.

One participant acknowledged that even though Gylfason's presentation and related paper made the innovative move toward linking questions of growth performance in mineral-rich countries with social policy, the analysis was situated within the framework of new growth theories with their emphasis on investment in human capital (health and education), and this is a somewhat narrow approach to social policy and development in general. Also, the focus on growth rates sidelined the fact that most governments are actually interested in "level" effects—that is, if mineral rents allowed countries to make a jump in their income level, then low to moderate growth rates would not be considered a problem. This raised the related question of how mineral-rich countries could embark on more fundamental structural transformations that would diminish the reliance of future generations on mineral revenues. Botswana was mentioned as an example where macroeconomic stability went hand in hand with low structural transformation and poor social development. In this context, another participant added that the crucial questions revolved around maximizing rents and appropriating rents. The second aspect leads to issues of taxation of rent, which actually minimizes distortions in the economy and provides revenue for social investment.

Given the presentation's emphasis on increasing human capital, and education in particular, the higher rate of return on investment for poor people was acknowledged to make sense from a microeconomic point of view. However, in a macro context the positive growth effect would depend on employment opportunities and the characteristics of labour markets.

Some participants also expressed doubts about the research finding that democracy increases efficiency and growth. It was argued that there is no such thing as

a natural development path based on a political system. Voting power is not enough to determine standards of living.

The discussants and other participants also commented on the econometrics and correlations used, their validity and the fact that they do not represent causation. The fact that social relations are usually left out of such an analysis was deemed problematic. There was also a proposal to use dynamic growth models to look at changes over time, in order to verify whether experiences had been different in other periods.

Session 2: State Capacity and Social Policies in Mineral-Rich Countries

Can revenue from mineral extraction constitute a sustainable source of finance for social policies? What are the linkages between mineral wealth, social policy and human welfare? What are the roles of domestic institutions and state capacity in mineral-rich countries? These are some of the questions explored in the papers presented during this session. Both presentations

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Evelyn Dietsche's presentation on "Institutional Change and Developmental State Capacity in Mineral-Rich Countries" had two objectives: first, to critically assess the role of institutions and the domestic conditions for institutional change in mineral-rich countries; and second, to explore in more detail how resource extraction is taxed, and what impact fiscal regimes and the concepts that have guided their design may have on the prospects for building state capacity. Given that not all mineral-rich countries have failed to promote development, she challenged the hypothesis that negative performance is inevitable. At the same time, however, there is no consensus in the literature on the factors that have driven economic and social development in these countries.

In her presentation, Dietsche noted that while the quality of institutions matters, it is important to identify the conditions under which institutions change. If countries are able to improve the quality of their institutions, this contradicts the supposed inevitable negative outcome produced by resource exploitation (that is, the resource curse). She bemoaned the lack of discussion on how institutions actually change and the requirements for bringing about such change. She argued that a negative institutional legacy can only be overcome if there is scope for policy actors to introduce a process of positive institutional change despite prevailing structural conditions. However, there is neither theoretical nor empirical clarity about the conditions that favour such action.

Dietsche also noted the measurement problems regarding what constitutes a "good institution". How should institutions and their quality be assessed? Often, what is viewed as constituting a good institution is based on subjective assessments by particular interest groups, and not on objectively acquired knowledge. According to Dietsche, successful countries are characterized by the ability of policy makers to build a state apparatus that provides an effective infrastructure for advancing economic and social development.

She then went on to discuss the conditions for institutional change, particularly in relation to revenue policies and political bargaining over resources. In the context of distributive struggle, convergent economic interests of two or more relevant social interests groups can tip the political balance toward positive institutional change. It is less clear when and how such convergences evolve, and who the winners and the losers are. Inefficient outcomes can also arise in such struggles, if potential losers block change, or potential winners cannot credibly commit to compensating powerful losers.

Dietsche next discussed the role of taxation in state capacity building. Resource extraction allows governments to generate revenue with relatively little public administrative capacity and without taxpayer representation in fiscal decisions. In turn, broad-based taxation benefits the quality of institutions and governance because the imperative to raise revenue on mobile assets provides a positive stimulus for state capacity building. This is due to the fact that mobile resources (income, capital and, to a lesser degree, labour) have the option to exit, if there is no minimum consensus on the tax policy. The relative bargaining power of different interest groups is important to understanding how to build state capacity and to change existing institutions toward better management of assets and revenues.

Might the design of fiscal regimes contribute to undermining state capacity building and institutional change in the long run? Regarding fiscal regimes as they apply to mineral taxes, Dietsche summarized two types: royalty/tax systems and contractual systems. Royalty/tax systems allow companies to take full control of production processes, and in return they pay taxes and royalties. The fiscal terms are usually set unilaterally by the government or negotiated with private investors. These systems are more typically found in developed countries where legislation spells out the tax policy for the sector. Contractual systems include production-sharing contracts and service agreements. These are found more often in developing countries. Fiscal terms, which are often kept confidential, are typically negotiated between the executive and foreign investors.

Dietsche noted that the political economy of taxation predicts that greater resource revenues undermine state capacity building and truncate institutional change. This proposition raises the question of the conditions under which mineral-rich countries might nevertheless be able to pursue positive institutional changes. She suggested three possible scenarios: (i) if immobile asset holders can align themselves with domestic constituents with whom they share a common interest with regard to the management of assets and revenues, so as to achieve positive development outcomes; (ii) if other domestic social and political conditions (such as effective veto powers by political constituencies) push political elites to seek legitimacy and build state capacity, despite the independence from broad-based revenue collection granted by mineral revenues; (iii) if the taxation of the mineral sector produces some form of administrative capacity which also serves the efficiency of resource revenue spending.

One of Dietsche's main conclusions was that the key challenge for mineral-rich countries is not a purely financial one; to aim at more revenues—as a number of countries have done until recently—is not sufficient. The main challenges were political and social, she argued, in the sense that those who could influence policy making need to gain an interest in the pursuit of social policies that are effective for development.

Following Dietsche's presentation, the thematic paper titled "Social Policy and State Revenues in Mineral-Rich Countries" was presented by its lead author, Leonith

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