

# Governance, resource curse and donor initiatives

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Petrad, Stavanger 6 October 2008

Delegation from Iraq

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# Plan

## Part 1. Governance

- What is good governance?
- Why is it important?
- How can we measure good governance?

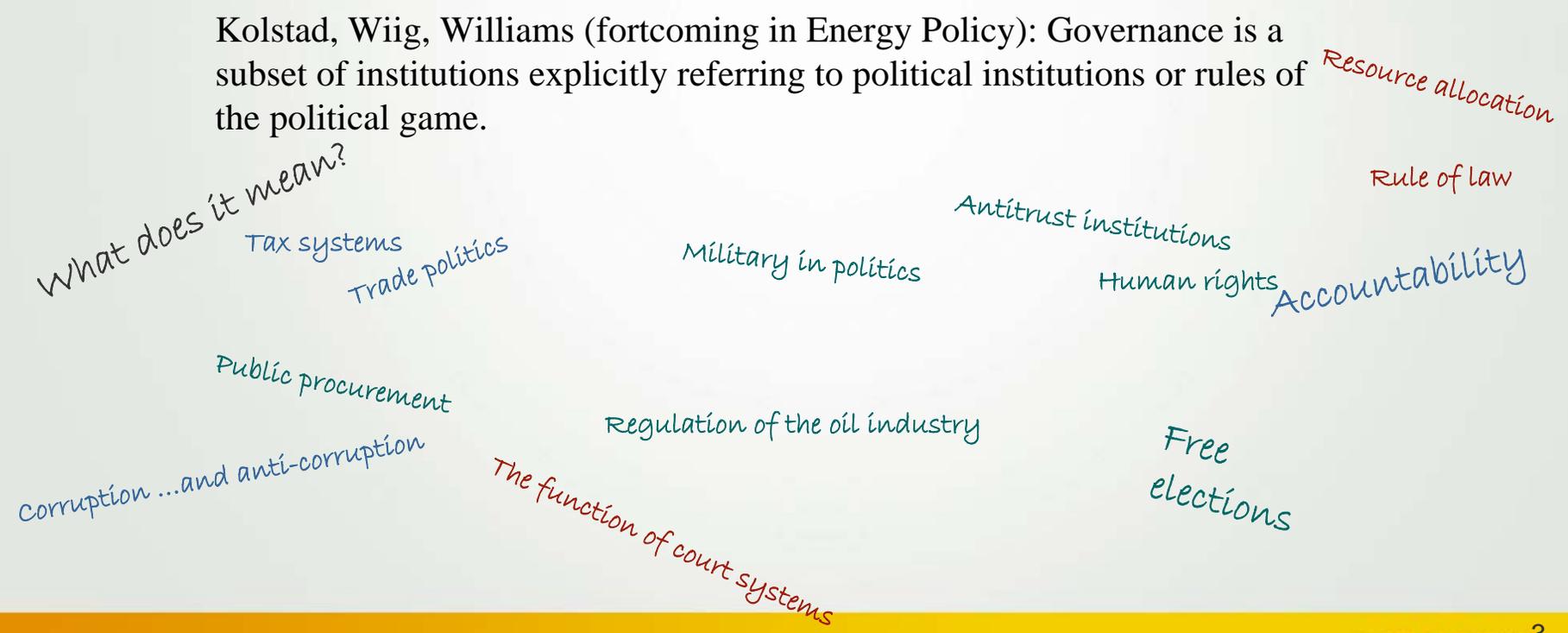
## Part 2. The resource curse and the importance of governance in resource rich countries

- Focus on political economy (PE) models of the resource curse
- Policy implications
- Some donor initiatives
  - Transparency and the EITI
  - Petroleum related aid
    - Window dressing initiatives or research based?
- Conclusion

# The term 'governance'

“the traditions and **institutions** by which **authority** in a country is **exercised**. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies...” Kaufmann, Kraay, and Zoido-Lobato (1999a, p. 1)

Kolstad, Wiig, Williams (forthcoming in Energy Policy): Governance is a subset of institutions explicitly referring to political institutions or rules of the political game.



# Governance and corruption are not the same

## Corruption

- Abuse of public office for private benefit
- Abuse of entrusted authority for private benefit
- Corruption, poor service delivery, weak investment climate and growth are outcomes of weak governance
- Corruption can be a response to both beneficial and harmful rules
- Governance is a key door to anticorruption

## Corruption can take many forms

- Involves often money, but not necessarily...(employment, gifts..)
- Corruption can take many different forms
  - Bribery
  - Fraud
  - Patronage
  - Embezzlement
  - Extortion
  - Bureaucratic- Petty
  - Political- Grand
  - Rent seeking

Glossary:

See <http://www.u4.no/document/faqs5.cfm#grandcorruption>

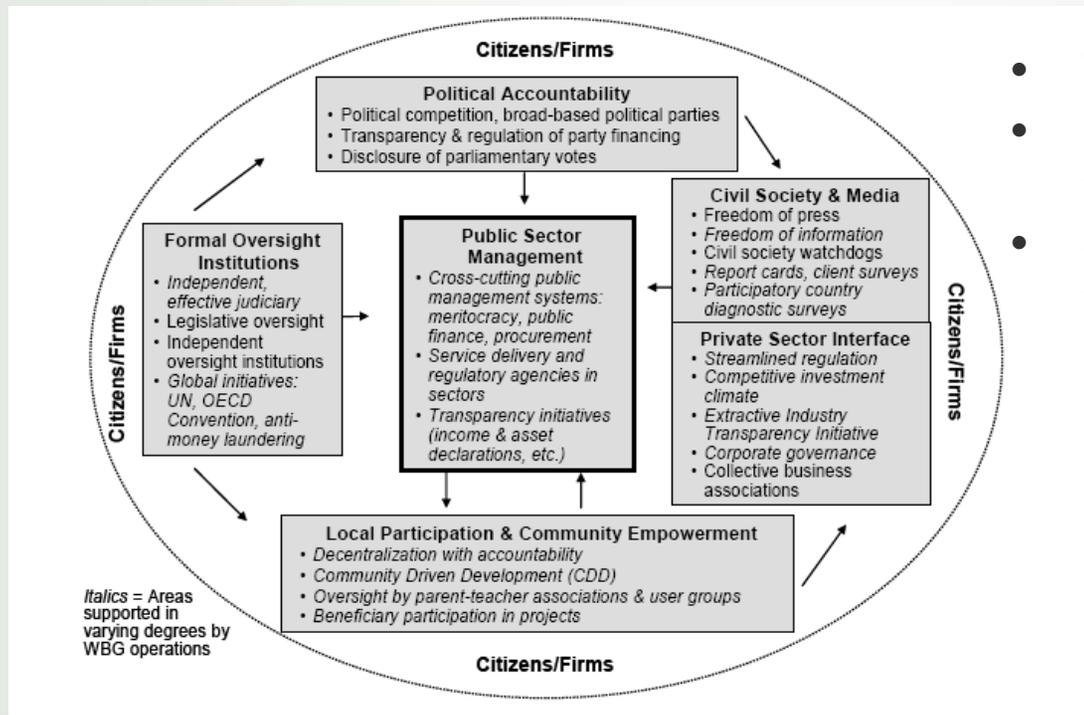
# Private – private corruption



Kellogg Brown  
Root

Difficult to draw a borderline private/private –  
private/public

## World Bank entry points for governance reform



- Vertical accountability
- Horizontal accountability
- Societal accountability,

## Sectors: Infrastructure and oil. Also in Iraq?

- Washington Post. July 17, 2006
  - About 10 percent of Iraq's refined fuels and 30 percent of its imported fuels are being stolen
  - Donors shifted billions of dollars from longer-term infrastructure into shorter-term projects to reduce corruption
- International Herald Tribune FEBRUARY 5, 2006.

Iraq's finance minister: Insurgents reap 40 percent to 50 percent of all oil-smuggling profits in the country. Infiltration refinery. Tap the pipeline, empty the trucks and sell the oil or gas themselves. "It's gone beyond Nigeria levels now where it really threatens national security," The insurgents are involved at all levels.“

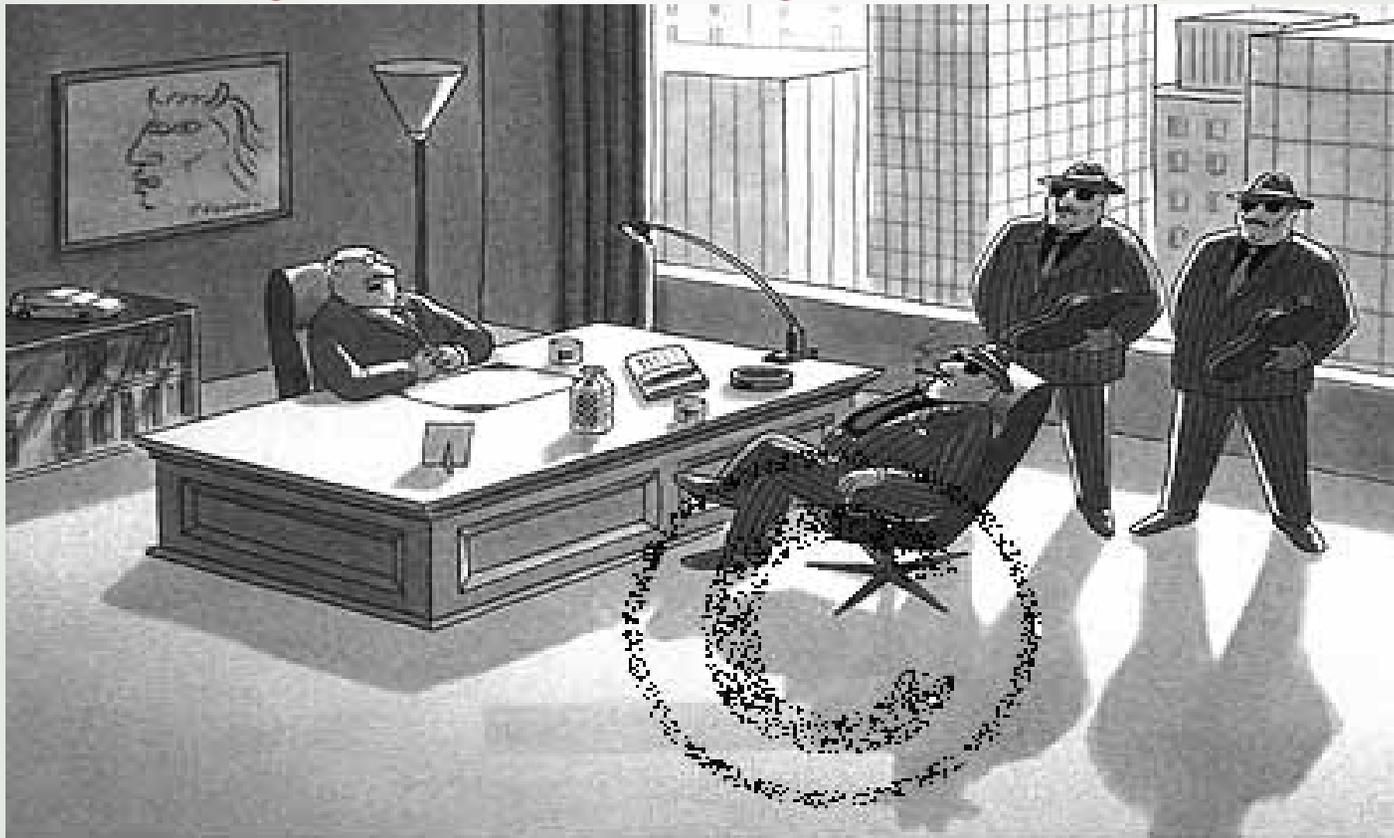
\$1.3 billion in misspent military contracts.
- NYT Oct 2 2004. The Hussein government has pocketed more than \$10 billion from the six-year oil-for-food program, which used \$64.2 billion in Iraqi oil sales to pay for food, medicine and other goods from 1997 to 2003.
- Improved since 2007??

## Two perspectives on why governance is important

- A. Consequentialistic perspective: Good governance – essential to economic growth
  - Important for service delivery to the poor
  - Important for receiving aid and for efficient aid?
  - But what if one find that corruption grease the machinery?
- B. Good governance – is important in itself
  - Corruption undermines other institutions/ persons ability to take their responsibility
  - Kant's categorial imperative as a variant
    - Treating people like means rather than ends is wrong.  
Lack of good institutions makes this possibilities

Corruption undermines moral division of labor (e.g state and citizens)

## When legitimate business gets too corrupt ...

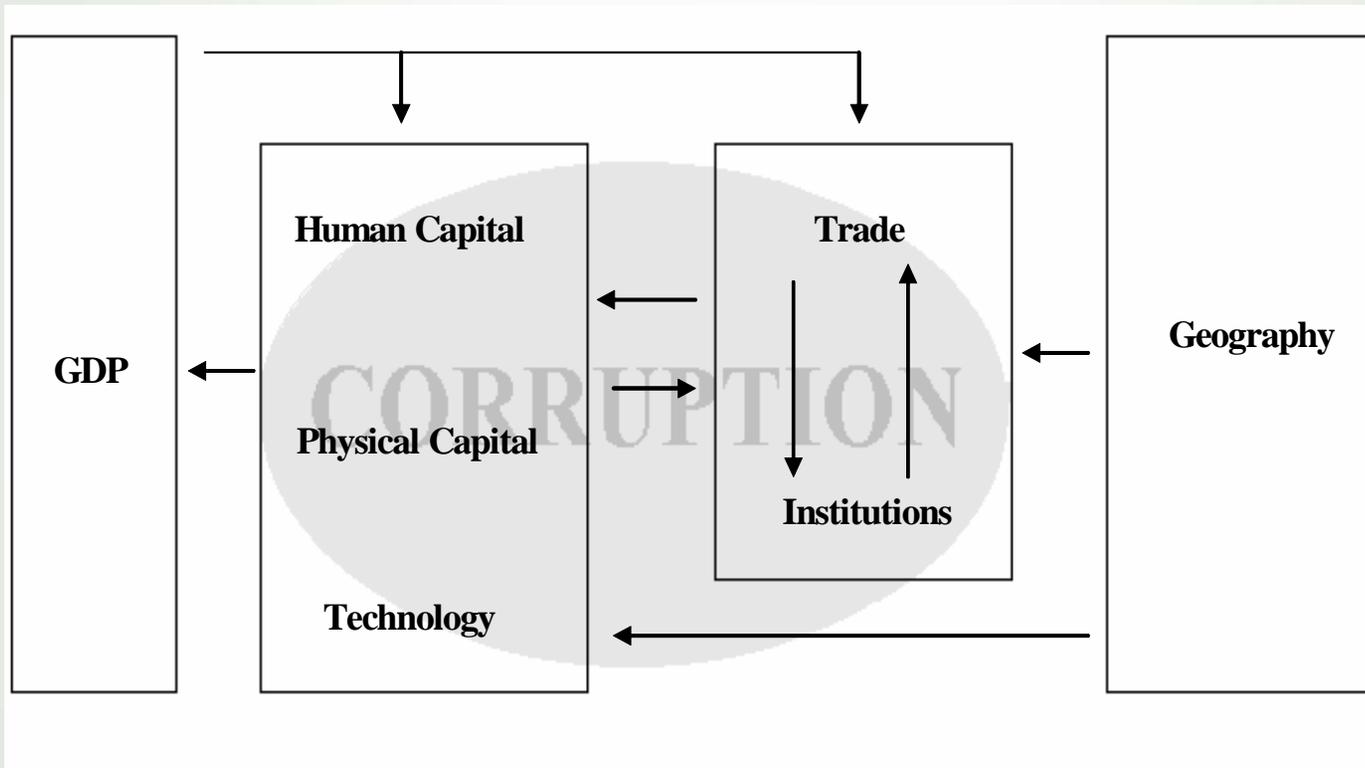


"I'm thinking of getting back into crime, Luigi,  
- legitimate business is too corrupt."

- Photo: Fjeldstad



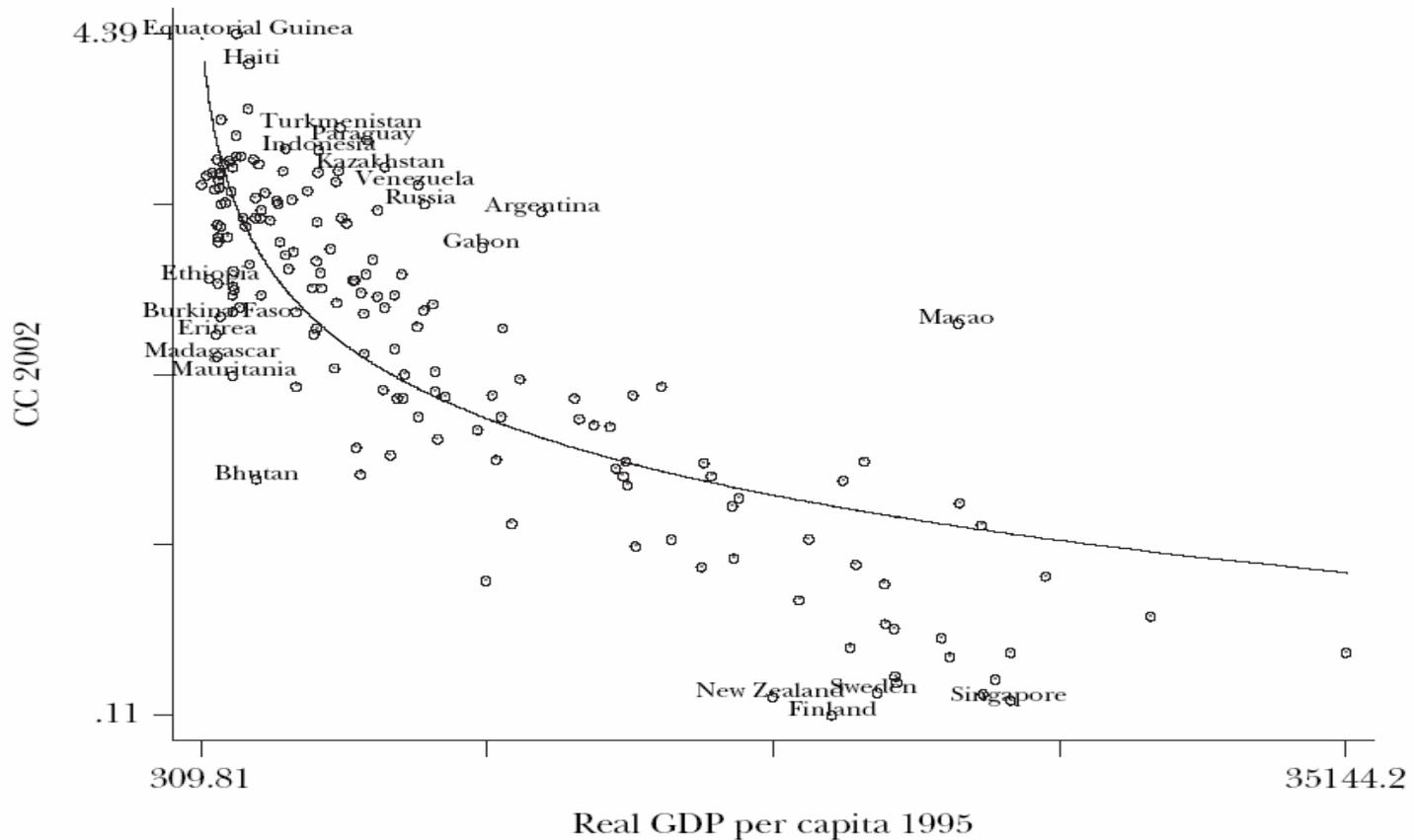
# Corruption influenced by institutions and influences key determinants (labor, capital and technology) of gross income



# Strong correlation between GDP per capita and corruption ranking

Figure 1

## Corruption and Income



Note: The graph depicts the regression line of corruption (CC 2002) on real GDP per capita (in logarithms) 1995.

## What determines variation in corruption

- Corruption is closely related to GDP per capita.
- Corrupt countries have significantly lower levels of human capital stock
- But still, huge variation at a given level of income
  - Corrupt countries are less open.
  - Corrupt countries regulate both entry to the market and the press more.
- Endogeneity and omitted variables

Corruption again an outcome of weak institutions

# Macro-evidence: Corruption and economic growth

*Cross-country regressions provide inconclusive evidence*

*Source: Fjeldstad 2006*

<i>Who</i>	<i>How</i>	<i>Results</i>
Maoro (1995)	56 'risk factors' for 67 countries (BI 1980-83)	Corruption lowers investment, thereby lowering economic growth
Svensson (2005)	Updated Maoro's calculations. ICRG's corruption indicator averaged over 1982-2000.	Less corruption correlated with higher growth – but not significantly different from zero
Tanzi & Davoodi(2001)	Cross-section of 97 countries	Corruption lowers growth
Brunetti, Kisunko & Weder (1998)	Corruption index by WB/UB – sample of 41 countries	Insignificant results
Abed & Davoodi (2002)	Cross-section of 25 transition countries	Insignificant results
Mo (2001)	Cross-section of 45 countries	Significant impact of corruption on growth
Meon&Sekkat (2005)	Significant. Stronger impacts in countries with a low quality for governance	

## Macro-evidence: Impacts of corruption on FDIs and capital Inflows

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### *Cross-country regressions provide inconclusive evidence*

*Source: Fjeldstad 2006*

<i>Who</i>	<i>How</i>	<i>Results</i>
Alesina & Weder (1999)	Corruption indicator derived from PRS. FDI data for period 1975-1990	Corruption found to have insignificant impact on FDI
Okeahalam & Bah (1998)	Data from sub-Saharan Africa – smaller sample	Insignificant
Wei (1997/2000)	Data on bilateral capital flows between 14 source and 45 host countries in 1990 and 1991	Significant negative impacts on FDI, ...but no difference between East Asia and other regions.
Aizenman & Spiegel (2003)	BI-data	Negative impact of corruption on the ratio of FDI to total capital accumulation
Abed & Davoodi (2002)	Cross section of 24 transition countries	Negative impact
Habib & Zurawicki (2001; 2002)	Corruption has larger negative impact on FDI than local investment	

## Macro-evidence: Impacts of corruption on international trade

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***Cross-country regressions provide inconclusive evidence***

***Source: Fjeldstad 2006***

<b><i>Who</i></b>	<b><i>How</i></b>	<b><i>Results</i></b>
Lambsdorff (1998, 1999)	Bilateral trade data (1992-1995) for 18 leading exporting and 87 importing countries	Significant impact Some countries found to have competitive advantages in trade with countries perceived to be corrupt - explained by differences in exporters' willingness to pay bribes
Wei (2000)	'Natural' openness gives both low corruption levels and high import propensity. But, effects of corruption on the reported levels of international trade low	
Gatti (1999)	Insignificant weak two-way relationship between corruption and trade barriers (35 countries)	

## Macro-evidence: Impacts of corruption on public expenditure

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**Cross-country regressions provide inconclusive evidence, but indicate impacts on the composition public expenditures and the quality of infrastructure**

Source: Fjeldstad 2006

<b>Who</b>	<b>How</b>	<b>Results</b>
Mauro (1997)	Corruption indicator from PRS – 94 countries	Claims to find evidence.
Tanzi & Davoodi (1997)	Panel data from PRS & BI for 1980-95	Claims that corruption lowers quality of infrastructure
Gupta, Davoodi & Tiongson (2001)	Countries with high level of corruption associated with inefficient government services and low quality of public <b>health</b> services	
Esty & Porter (2002) and Tanzi & Davoodi (1997)	Claim to find significant evidence for <b>over-investment in public infrastructure</b> – but poor quality of data and mixed results undermine the credibility of this link	
Mauro (1998) Gupta <i>et al</i> (2002)	<b>Corruption lowers government spending on education</b>	

## Macro-evidence: Impacts of corruption on public revenue

**Cross-country regressions indicate impacts on public revenues & aid**

Source: Fjeldstad 2006

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<b>Who</b>	<b>How</b>	<b>Results</b>
Tanzi & Davoodi (1997)	Panel data from PRS & BI for 1980-95	Lower government revenues
Alesina & Weder (2002) ['Do corrupt governments receive less foreign aid?' AER]	Use corruption variable provided by PRS – not cross-checking results by using other Indices	<ul style="list-style-type: none"><li>- Foreign donors do not discriminate against corrupt countries</li><li>- Corrupt countries are more apt to attract foreign aid from OECD countries</li></ul>
Johnson <i>et al</i> (1998) Friedman <i>et al</i> (2000)	Countries with high levels of corruption tend to have a lower collection of tax revenues in relation to GDP, controlling regressions for income per head	

## Summary of findings from cross-country regressions (1)

To the extent we can measure corruption in a cross-country setting, it provides:

1. Inconclusive evidence on how it affects:

- Economic growth
- FDIs and capital inflow
- International trade

2. Indicates that it has negative impacts on

- Composition and quality of public expenditures
- Government revenues

## Summary of findings from cross-country regressions (2)

- No studies find a positive result
- But institutions play a significant role in economic growth. Acemoglu et al 2005
- Theories and microstudies (firm level surveys, PETS and service provider surveys): corruption impede economic growth and service delivery
  - Uganda (Reinikka & Svensson 2004, 2006): Primary schools received on average only 13% of central government allocations to non-wage expenditures (1991-95)
  - Indonesia (Olken 2005):
    - 28% of funds allocated to village road building projects were stolen on average

Furthermore:

- And there is double dividend of good institutions in resource rich countries
- And even if one finds that corruption fuels the machinery, it is wrong (non corruption has a role in itself)
- There are methodological problems

## Limits to cross-country research on corruption

- Concerns about perception biases
- Indices based mainly on the perceptions of business people, investors and 'country experts' often miss corruption experienced by ordinary people
- Significant standard deviations in the data
- Countries with similar rankings may have very different business climates (and growth rates) because corruption is concentrated in different sectors and at different levels in the political system (petty versus 'grand')
  - China - Russia
- Conceptually, macro-level determinants cannot satisfactorily explain the within-country variation of corruption (South Italy)
- The aggregate nature of the data tells us little about the relationship between corruption and individual agents, such as service providers or firms

# Measures of governance

Not everything that counts can be counted (Einstein)

Measurement errors for all measures

- Formal rules (de jure). Details of the constitution, legal and regulatory environment, the existence of anti corruption commissions, independent auditors (Polity)
- Practical applications or outcomes of these rules (de facto). Do households perceive that government is corrupt?
- Experts views (de jure)
- Results of surveys

# The most widely used Governance indicators & Corruption indices

## *International Country Risk Guide (ICRG)*

– *Economic, financial and political risk* monthly ratings for 161 countries (<http://www.prsgroup.com/>). Experts

## *Freedom House*

– annual ratings of political rights, civil liberties and the functioning of government in 192 countries. <http://www.freedomhouse.org/template.cfm?page=5>

## *Transparency International's 'Corruption Perception Index'*

– annual ranking of 180 countries in 2008. See [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi/2008](http://www.transparency.org/policy_research/surveys_indices/cpi/2008)

## *The Polity Index*

– consists of six component measures that record key qualities of executive recruitment, constraints on executive authority, and political competition. See <http://www.systemicpeace.org/polity/polity4.htm> . [polity 4 Iraq2006.pdf](#)

## *The World Bank Institute ('KKM'-indicators)*

– annual (from 1996 to 2007) for 212 countries. <http://info.worldbank.org/governance/wgi/index.asp>

## KKM indicators. *Six dimensions of governance*

- *Voice and accountability*  
On citizens ability to participate in selecting their government, freedom of expression, freedom of association, and a free media
- *Political stability – and absence of violence*  
Perceptions about the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means
- *Government effectiveness*  
The quality of public services, the quality of the civil service and the degree of its independence from political pressures.
- *Regulatory quality*  
The ability of the government to promote private sector development
- *Rule of law*  
Different agents confidence in the rules of society, their respect for the rules, and the quality of contract enforcement, police, courts, and the likelihood of crime and violence.
- *Control of corruption*  
Misuse of public power for private gain. Includes high and low levels – and also ‘capture’ of the state by elites or large firms.

No aggregate

Indicators as drivers of change?

[iraq\\_sc\\_chart\\_print.pdf](#)

# Governance Matters 2008

Worldwide Governance Indicators, 1996-2007

HOME ACCESS GOVERNANCE INDICATORS RESOURCES FAQ

All Indicators for One Country One Indicator for Selected Countries Country Data Reports World Map

1 Select Country

IRAQ

2 Select Comparator

Year

3 Select Year(s)

- 1996  1998  2000
- 2002  2003  2004
- 2005  2006  2007
- all



Chart



Table



Time Series

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IRAQ

Governance Indicator	Sources	Year	Percentile Rank (0-100)	Governance Score (-2.5 to +2.5)	Standard Error
<a href="#">Voice and Accountability</a>	8	2007	9.6	-1.29	0.15
	7	2003	4.8	-1.60	0.17
	5	1998	1.9	-1.93	0.23
<a href="#">Political Stability</a>	7	2007	0.5	-2.82	0.23
	6	2003	0.0	-2.36	0.25
	5	1998	1.9	-2.34	0.25
<a href="#">Government Effectiveness</a>	7	2007	1.9	-1.68	0.22
	7	2003	2.4	-1.60	0.19
	4	1998	0.5	-2.12	0.16
<a href="#">Regulatory Quality</a>	6	2007	7.3	-1.35	0.23
	6	2003	6.3	-1.42	0.20
	5	1998	0.0	-2.76	0.30
<a href="#">Rule of Law</a>	8	2007	1.0	-1.89	0.18
	8	2003	1.9	-1.72	0.16

## Other governance measures

- Doing business data.. Quality of governance that matters directly for trade and industry
  - Starting business
  - Dealing with licenses
  - Employing workers
  - Registering property
  - Getting credit
  - Protecting investors
  - Paying taxes
  - Trading across borders
  - Enforcing contracts
  - Closing a business

## The Doing Business -data

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These parts of governance are critically important to stimulate private sector development, including FDI, increasing competition and reduce the relative size of the informal sector.

These measures might be easier to reform. Easy to learn what are the main barriers and how to improve bureaucratic routines

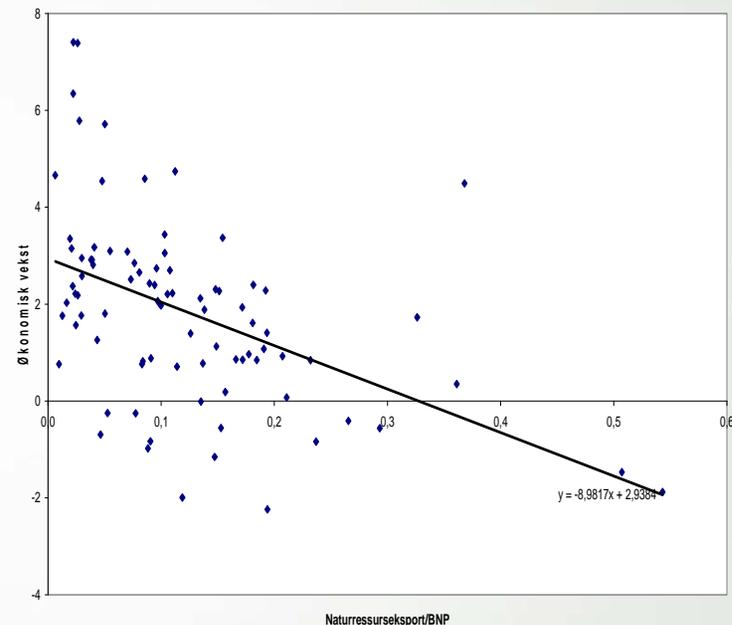
For comparison, easy to get information about other countries' experiences

The WB collects information about what has worked, where and why

There are weakness in the data

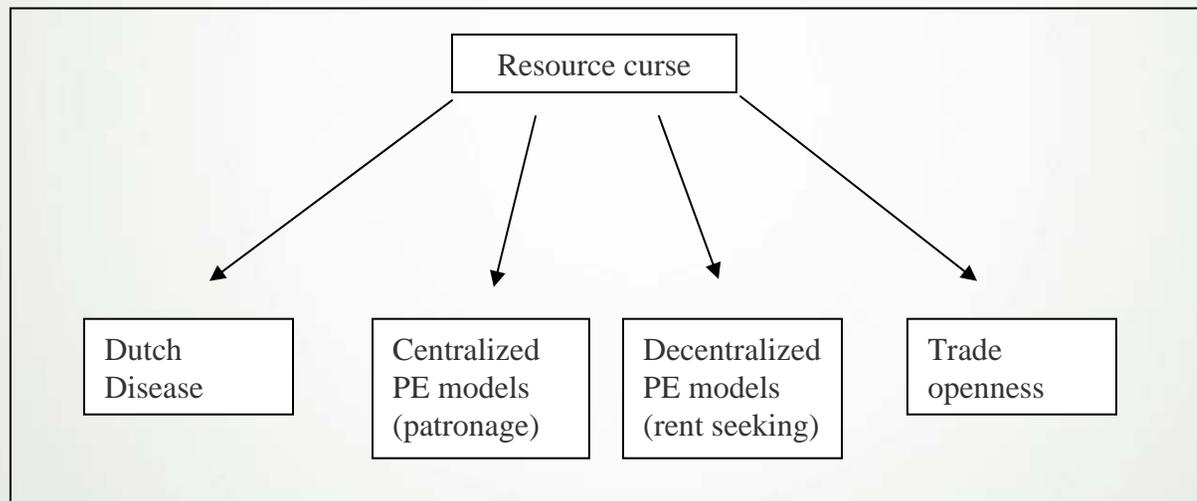
## Part 2. Governance and the resource curse.

- What is the resource curse?
  - In the last 40 years there is a negative robust correlation between the share of resource exports in GDP (horizontal axes) and economic growth (vertical axes)
- This correlation is valid also when many other factors are controlled for. **But countries with good institutions normally do not experience a curse.**
- There are weaknesses with the existing studies
- Source: Torvik 2007



## Four approaches to the curse

- Diversity in mechanisms
- Identification of mechanism is important for beating the curse



# Political Economy Models (PE)

## *Unit of analysis*

- *Centralized* models focus<sup>↑</sup> on the decisions of the **political elite**, and how these are affected by natural resources (Caselli and Collingham, 2007).
- *Decentralized* models, or rent-seeking models, by contrast, analyze the incentives of **private agents** and the effect of resources on their allocation of effort between activities.

## Impact of increases in resources: Centralized models (patronage)

- It increases the value of staying in power since this means controlling greater revenues
  - Spend more resources to stay in power
    - Patronage; offering of jobs to political supporters or initiate large infrastructure projects (white elephants).
    - Reduce tax and thereby inefficiencies.
  - Longer time horizon and more optimal extraction path

In sum: Ambiguous

- It increases the likelihood that others will challenge the government for power
  - Spend more on fighting challengers
    - Repression, patronage
    - Improve opponents outside options

In sum: Ambiguous

Total sum: Effect of resources are AMBIGUOUS.

## Institutions determine where a country ends up

The choice between special and distortive policies and general and productive measures is critical for where we end up. This depends on:

- Degree of credibility
  - Specific policy might be more credible than general measures
- Impartiality enhancing institutions
  - Institutions that reduce the possibility or attraction of favouritism versus acting in the general public interest
    - Democratic accountability is key
    - Type of democracy matters

## Impact of increases in resources: Decentralized models (rent seeking)

Individuals choose between using their effort on rent extracting activities, and using them on productive activities.

Also here two opposing effects

- Increasing resource rents increase income
- Displacement effect in productive sectors since more entrepreneurs choose to become rent-seekers.
  - Compounded further if there are external effects of rent seeking activities or increasing returns to scale in productive sectors.
  - Studies vary regarding how this external effect is modelled.

**Ambiguity again resolved by institutions; again impartiality enhancing institutions like rule of law**

## Decentralized versus centralized models

- Strong evidence that Political models play a key role explaining the curse, but mixed empirical evidence on the relative importance of these models.

## Openness to trade closely linked to the political economy explanation

- Openness to trade an impartiality enhancing institution
  - Increase profitability of private sector
  - Democratic accountability (middle class)

## Do current donor initiatives reflect available evidence

- Impartial enhancing institutions
  - Vertical accountability in order to control political capture and patronage; democracy
  - Private sector development in order to reduce the incentives for private capture (rent seeking)

**Support good institutions** (governance) is a key for all agents (government, firms and donors)

- Here focus on two donor initiatives
  - EITI
  - Petroleum related aid
    - Norwegian aid
  - None of these have been rigorously being evaluated
    - But Kolstad and Wiig Forthcoming World Development
    - Kolstad, Wiig, Williams. Forthcoming Energy Policy

## The Extractive Industries Transparency Initiative (EITI)

- An important initiative
- A voluntary initiative.
- Verification and full publication of company payments and government revenues from oil, gas and mining.
- 23 candidate countries have so far committed to the EITI process.
- None are yet EITI compliant countries.
  - Various steps of preparation.
  - No country has yet completed an EITI validation, but only one country (Azerbaijan) is in the process of being validated.
  - The reach of the initiative is somewhat limited; candidate countries only comprise 6.4 per cent of global oil production and 7.6 per cent of proven global oil reserves.



## Transparency (T) and corruption: Mechanisms (1)

How will increased T influence the decision of a potentially corrupt agent?

- Detection -
- Law enforcement (buy their way out of punishment) -
- Bribe size
  - Bureaucrats lower bargaining power -
  - Increases the costs of being corrupt +
- Disentangle other variables (wage, moral costs, risk aversion, bribe) -

**Transparency is likely to reduce corrupt behavior**

## Mechanisms (2)

Lack of transparency makes it difficult to provide incentives and select honest bureaucrats

- Point of departure: Benevolent principal and asymmetric information
- Lack of transparency increases the bias and variance of a signal: difficult to expose corruption and to reward clean behaviour
- Lack of transparency makes it difficult to signal or to screen the type

## Mechanisms: (3)

### Information is power and rent

- Gain due to information advantage. Why give it away?
  - Gains and costs from non-transparency (rent and free press)
- The government controls information and information capture influences political outcome and reduce accountability
  - Transparency reduces the possibilities of rent seeking activities
  - How to punish the existing government if information is lacking
  - Free media is important

## Mechanisms (4)

### Information failure undermines cooperation and trust

- Windfall gain makes it more likely to deviate from cooperative agreement.
- Lack of information: Harder to uphold cooperative agreement
- Social norms against corruption may be hard to uphold in the absence of information

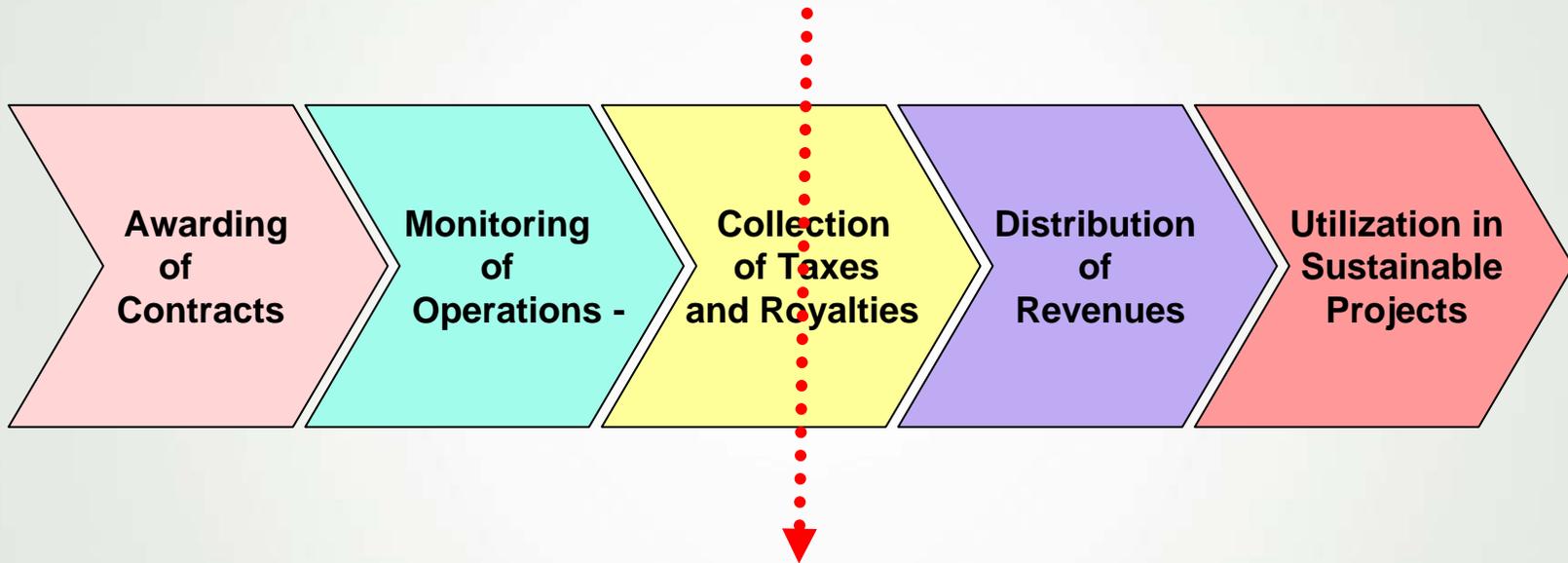
## Transparency can cause problems

- Providing information also has a cost
- Makes identification of corrupt officials easier (Bac, 2001)

## Transparency important, but insufficient and lack of empirical evidences

- Need ability to process information (education)
- Need ability and incentives to act on the processed information
  - Vertical accountability/democracy
- When corruption is collusive, not much transparency can do
- We also introduced transparency in natural resource growth regressions. Replicated Sachs and Warner 97 and Mehlum et al 06. Transparency and its interaction term with natural resources were found insignificant in explaining the curse

# EITI and the Value Chain



**EITI intervention  
in one stage only**

## Faces of transparency and resource curse

Good institutions play a role for reducing the resource curse

- Rentseeking: Productiveness in private sector
- Patronage and expenditure: Institutions in public sector
- But transparency in terms of revenue does not play a part in these models. EITI may focus on the wrong set of issues
- It also lacks effective sanctioning mechanism

## The Norwegian Oil for Development Programme

- Launched in 2005
- Integrate different activities into one programme
- 45.6 million USD in 2008 or approx. 2% of Norwegian bilateral aid
- Sudan, East Timor and Angola are the largest recipients.
- Three integrated themes cover 90% of allocations
  - Resource management
  - Revenue management
  - Environmental management and control

Governance as overarching theme but see few direct governance projects
- Lack a focus on overarching governance issues and the current focus on enhancing capacity of government and civil service does not change institutions
- Lack a link to general development issues
- Narrow anti-corruption strategy (civil society).
- Integrity and motivation
- Lack an analysis of political economy considerations

## Key questions for you to discuss?

**What are the most pressing governance challenges in your country?**

**What are the main entry points and obstacles to governance reforms in your country? Who will loose?**

**To what extent does IRAQ risks a resource curse (confer political economy models of the curse)?**

**How can the donor community better assist your country on governance reforms? What further actions would you like to see from the Norwegian aid communities?**

## Conclusion

- Good governance is important for development.
- There are many aspects of governance – not one thing
  - Wide variations in the way corruption is organised and how incomes from corruption are spent. These variations are likely to produce different economic outcomes
- Higher order principles or levels of governance play the key role (vertical accountability)
- A double dividend of good governance in resource rich countries.
- Current donor initiatives are not addressing the policy challenges from the resource curse literature (political economy models)
- More work needed on institutions, their change and debundling.