Policy-Making in Resource-Rich Countries

Lessons from Zambia

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Introduction

Economic growth depends on the availability of natural resources, the accumulation of physical and human capital, efficiency in resource allocation, and the acquisition and application of modern technology. A crucial question then is how the institutional and policy environment should be organised to facilitate the accumulation of production factors and their efficient allocation, as well as the introduction of enhanced technologies. In this paper we will discuss this issue for the case of a natural resource abundant economy, where the economic structure and the implied incentives create special problems. We will in particular look at the character and role of institutions and interest groups that emerge in such a setting.

One would presume that countries with an abundance of natural resources would stand a better chance of developing than resource-poor countries. However, recent experiences in less developed countries paradoxically show the reverse. Sachs and Warner (1995) show that countries with a high share of natural resources in their exports in 1971 grew slower than the average between 1971 and 1989. Likewise, Auty (1998) shows that between 1960 and 1990, resource-deficient developing countries grew two to three times faster than resource-rich ones. Development was particularly bad in small countries that based their development on hard minerals (such as copper). This group actually saw per capita incomes decline by 0.2% per year. The poor results remain even if one controls for trends in commodity prices. Why do we get these results?

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To attempt to explain this we will in this paper investigate the case of Zambia (see also Bigsten and Kayizzi-Mugerwa, 2000, for a more detailed review). Its economy has been based on copper mining, and like many other resource-rich developing countries it has a dismal growth record. Over the last three decades per capita incomes in Zambia have been halved! We will in this paper show how policy-making in this resource-abundant economy has been biased by the availability of resource rents. We will then discuss the implications of our results for the policies of international financial institutions and other donors, and also discuss the problems of policy-making in natural resource abundant countries.

Theory review

In recent years there have been numerous studies attempting to explain inter-country differences in growth or per capita incomes, and we have seen a number of attempts to explain the causes of growth failure in Africa in general, and among resource-rich countries in particular (e.g. Sachs and Warner, 1997; Easterly and Levine, 1997). Many factors correlate with poor economic performance, but one of the most important factors suggested by recent research is lack of openness to the rest of the world. The survey by Collier and Gunning (1999a) identifies inward-orientation as one of the major explanatory factors of Africa's slow growth. This result makes the poor performance of resource-rich Zambia even more startling, since the country has been trading extensively with the rest of the world. It should be noted, though, that openness can be defined in different ways, and the share of exports in GDP is not a very appropriate one. The relevant measure is rather the size of the price wedges[1] between a country and the global market created by policy interventions. In this respect Zambia closed up from the 1960s onwards as it pursued an import substitution industrialisation strategy.

A common explanation of the problems of resource-rich countries is that an abundance of natural resources pushes up the exchange rate so that the wider industrial base loses international competitiveness. Sachs and Warner (2001) provide some empirical support for this notion that

[1] For example, if a country introduces a tariff of, say, 50% on an imported good, the domestic market price will exceed the world market price by 50%. The tariff then constitutes a wedge between the domestic and international price.

resource-rich economies are high-cost economies and that this has tended to stifle export growth outside the resource sector. This is referred to as Dutch Disease, but what it means is that the market signals that the country has its comparative advantage in, for example, the mining sector (Neary and van Wijnbergen, 1986; Kayizzi-Mugerwa, 1997). This is not necessarily something to deplore, but the literature also argues that the ownership of mineral deposits exposes the economy to patterns of domestic behaviour that may be detrimental to long-term growth (see e.g. discussion in Auty, 2001). First, to exploit the resources, government undertakes huge initial investments, which are largely irreversible. The huge size of the commitment ensures that resources continue to flow to the areas where mineral exploitation is concentrated. The mining activity by itself also has relatively little forward or backward linkages or external impacts that can stimulate more broad-based development. The sector generates large economic rents, the handling of which is both economically very important and politically very controversial. During mineral booms, most governments behave as if the inflows of resources are permanent, embarking on new projects, including import substitution. The basic economic structures are thus distorted, with the protected industry expanding, while agriculture and other unprotected sectors contract. When the boom turns to bust, the country finds it virtually impossible to reverse its policies. Strong economic interest groups have become entrenched by the large initial investments.

Another feature of natural resource dependence is exposure to unpredictable commodity price fluctuations. Deaton (1999) shows that copper prices have fluctuated widely, while the long-term trend in real prices has been downward. African countries have had problems in handling the resulting terms-of-trade[2] shocks effectively, and the problem is of course more severe the more dependent on one commodity that the country is. It has turned out to be virtually impossible to retain control of public expenditures when there is a commodity price boom (Bevan et al, 1990).

Zambia is not the only country to see commodity exports as a source of investment funds. Many have attempted, unsuccessfully, to use the funds as a basis for import-substitution. This has worked no better for resource-

[2] This means a change in the value (as opposed to quantity) of exports relative to imports. A rise in commodity prices would therefore be a positive terms-of-trade shock for commodity exporters; the value per unit of their exports would rise.

rich countries than for other countries. A country like Zambia should not switch to a strategy that does not exploit its abundant mineral resource. Africa in general is rich in natural resources but poor in human capital, which suggests that its comparative advantage will be in primary commodities for a long while to come (see e.g. Owens and Wood, 1997).

A key issue is thus how to avoid rent-seeking behaviour which leads to a waste of resource rents. It is important to understand how the institutional structure emerges and what needs to be done for growth-supporting institutions to develop. A government whose primary concern is its own short-term survival is unlikely to develop institutions and pursue policies that are good for economic growth. With special interest groups at centre stage, trying to push through their demands or pursuing various rent-seeking activities, the implied distortions are bound to lead to inefficiency. Resources are wasted and investors become cautious.

Over the last decade, Africa has taken strides in the direction of more democracy, but political systems are still very vulnerable and prone to abuse (Bratton, van de Walle, 1997). Civil society in Africa, including religious organisations, trade unions and other movements, have attempted to mobilise the population towards the culture of democracy and accountable government, but with limited success. The donors and the international financial institutions, as well as various domestic groupings, have put pressure on governments to democratise, and in a formal sense they have been successful, since the majority of countries now have multi-party elections. However, the character of the regimes that have emerged from the democratic process has so far not changed much relative to the old autocratic ones. The old political (and economic) elites have tended to maintain control and also to continue to misuse the system.

Zambia attempting import-substitution

In Africa, Zambia presents a good example of poor development in spite of an abundant natural resource, copper. At independence in 1964, the copper sector was the most important employer outside agriculture, and the main source of foreign exchange earnings and government revenue. As a consequence of this, miners and other mine workers became the most vocal and politically active groups of employees in the country.

Following the nationalisation of the mines in the early 1970s, copper rents were not primarily used to maintain the mines, but were used to finance an attempt to diversify the economy via the development of an import-substituting manufacturing sector. The mining revenues were also used to finance social services, particularly for those in the modern part of the economy. Agriculture and the rural population were neglected. Per capita incomes started to fall in the mid-1970s. This was initially due to the fall in copper prices, but the effect of this was soon to be overshadowed by the effect of the decline in copper production.

For a while the government tried to avoid adjustment. Instead it borrowed extensively, which led to serious foreign indebtedness. The government tried to maintain the public sector, and in an attempt to halt the decline in real wages, the government tightened the regulation of consumer prices and expanded its subsidies on basic commodities. A system of import licensing and administrative foreign exchange allocation was introduced. The control of prices for basic commodities also meant that state-owned companies supplying those goods made losses, which were covered via the budget.

Towards the end of the 1970s, economic reforms could no longer be avoided. During the 1980s, Kaunda's government started a series of structural adjustment programmes, with the support of the international financial institutions. However, under serious domestic opposition, especially from miners on the Copperbelt, the government invariably failed to implement important components of the reform packages. The switch from administrative controls to market forces directly threatened groups in charge of the control apparatus and to whom the rents accrued. The main problem with the reforms was thus that they tended to undermine the position of the ruling party's main political constituencies (see Bates and Collier, 1993).

The culture of subsidies, which the large mineral incomes had helped to sustain, became a serious liability. The subsidies could only be removed at high political cost. The import-substitution industry, which had thrived on high tariffs, also suffered from the decline of the copper sector. Rationing of goods and services became the order of the day, and a powerful committee was set up to allocate foreign exchange to 'priority' sectors and needs. As a result, rent-seekers became an increasingly powerful group, able to exercise their veto on prospective reforms.

Zambia attempting liberalisation

In 1991, a newly formed political party, the Movement for Multiparty Democracy (MMD), won power on a reform platform. The new party was a fairly broad coalition of trade unions, business interests, intellectuals and students. The new government took advantage of its broad popular support and tried to distinguish itself from the old government that was associated with economic controls and lack of credibility in managing the reform process. As soon as it was elected, it introduced its Economic Reform Program (ERP) with the goal of arresting the economic decline. The donors responded to the government's efforts by resuming their support to Zambia.

The new government undertook an extensive macroeconomic and market liberalisation programme. There was a rapid liberalisation of external trade and payments system and a movement towards a market-determined exchange rate. In an attempt to balance the budget, the government reduced expenditures very significantly and attempted to increase revenue. Both maize and fertiliser marketing were liberalised, eliminating the associated subsidies. Most of the labour market controls were also removed, and there was a far-reaching liberalisation of the financial sector. Together with the Economic Recovery Programme for the period 1991 to 1995, there was also a Rights Accumulation Programme (RAP) supported by the IMF. At the end of 1995 the government had made enough progress under the RAP to resume borrowing from the IMF. This was the first time that Zambia had actually completed an agreement with the Fund.

The Zambian Privatisation Agency (ZPA) was launched in 1992, but initially there was limited progress. The donors pressed for privatisation, while the government dragged its feet. One typical case was Zambia Airways, which at the time received a subsidy from the government equal to about one per cent of GDP. Flights to Europe were often crowded with non-paying passengers such as ministers and their relatives. The donors effectively forced the government to close the airline in 1994. In the second half of 1995 the privatisation process gathered momentum, and by the end of 1997 as many as 224 companies out of a total portfolio of 275 had been privatised. However, the privatisation of the "crown jewel", the state mining conglomerate, Zambia Consolidated Copper Mines (ZCCM), proved to be politically very hard. A difficult process of tendering was initiated in 1996, but the parties failed to reach foreclosure. The government then lifted the ZCCM privatisation out of the ZPA and assigned it to a former head of the company. It was finally privatised in March 2000.

The main development problem of Zambia during the last decade was the delayed privatisation of ZCCM. In its latter years the ZCCM made a daily loss of at least US$ 1 million, and in addition, it failed to pay suppliers such as the parastatal electricity utility ZESCO, which meant that its problems spread to the rest of the economy. ZCCM seems to have sold its output too cheaply, and typically paid 25% more than it should have for inputs. There was extensive asset stripping during the firm's last few years. When the mines were finally privatised the government did not get any money at all for the sale, but instead had to take over US$ 1 billion in bad debts. This should be compared to the sizeable sums that it could have obtained in the early 1990s when copper prices were high, or even in 1997 when the earlier privatisation attempt stalled. Annual production at the end of the century was down to 250,000 tonnes per annum, compared to 825,000 at the peak in the late 1960s. This trend has been reversed since privatisation, and production in 2001 is expected to be about 310,000 tonnes.

In spite of liberal policies, investors have been sitting on the fence. Foreign investment has almost completely bypassed Zambia. Since the investors' risk assessment depends on the credibility of policy reforms (World Bank, 1996) the persistent uncertainty in Zambia has caused investors to take a cautious attitude. The high level of indebtedness also raises the risk of policy reversal. Investment expansion thus requires long-term macroeconomic stability, and for this to be credible, debt burdens have to be manageable (Andersson, Bigsten and Persson, 2000; IMF and IDA, 2000). The inefficiency and corruption of economic management will be curtailed by privatisation. The problems of managing a rich natural resource remain, but some of the worst features of abuse of power should be curtailed. The stalled privatisation of the ZCCM and a whole range of scandals have undermined the credibility of the government. Even sensible reforms may be ineffective when the implementation is flawed. Therefore, the political process must also be transparent and coherent.

The politics of reform

The transfer of power in 1991 was almost unique in Sub-Saharan Africa at the time, since it occurred peacefully through an election. In the debate on the process, civil society was an important force for change. The four groups that have been identified are the business community, the trade unions, the churches, and academics and intellectuals. Still, as argued by Bartlett (2000), the 'older political logic' does not disappear just because a regime is under pressure from the wider society. In Zambia, some groups were effectively excluded from the process of change, and the outcome of the transfer negotiations paved the way for the resurgence of authoritarianism under the new MMD government. Within a reasonably short period of time it started to act almost as if it were a one-party state. The older political logic reasserted itself! Rent-seeking and clientialism were as prevalent as ever before, and corruption scandals were common. Conflicts were brewing and the government declared its first state of emergency already in 1993. With regard to the elections in 1996, Rakner, van de Walle and Mulaisho (1999, p. 35) argue that "the conduct of the elections proved that the Chiluba government was willing to compromise the rule of law, was intolerant of criticism and willing to exploit its majority position and control of government resources to undermine its opponents." Spoils politics is still very important. Continued corruption among ministers indicates that personal accumulation from state resources remains an important motivating force. The government has also made statements that top government positions should be reserved for party members and that development funding should be channelled to MMD-voting districts. The rent possibilities of politics are still a major motivating force in Zambia, and the emergence of a more active civil society has so far not changed the basic rules of the game.

During the last year many scandals have been revealed, and it seems obvious that rent-seeking is one of the most serious constraints on Zambian economic development. Among the scandals we may mention the cobalt pricing scandal. For the two last years that the industry was under state control, US$320 million in export revenue is unaccounted for. A government study launched in July 2000 found that during 1998–1999 cobalt had been sold at prices much below world market prices. This is certainly an example of asset stripping in the face of privatisation. Other examples are the transfer of money from the Ministry of Works to the ruling party, government payments to foreign firms that cannot be accounted for, diversion of oil tankers going to the National Oil Company, and many others.

Implications for donors

There are three aspects of the aid-policy relationship that may be considered, namely the impact of aid on the initiation of reform, on the policy content, and on the effectiveness of implementation. The content of the Zambian reform packages has largely originated from IFIs with limited original Zambian input. There is therefore an ownership problem, although conditionality has sometimes helped push reform forward, for example with regard to privatisation (see also discussion on Tanzania in Bigsten et al, 2001). A number of studies have shown that ownership is very important for policy efficacy, and that strict *ex ante* conditionality conflicts with ownership (IMF, 1998, Collier and Gunning, 1999b). In the case of Zambia the IFIs have had a strong interest in pushing Zambia's unwilling policy-makers to undertake enough reform to make aid justifiable, which in turn makes it possible for the country to service its debts with a semblance of order. The IFIs have therefore been very unwilling to pursue an alternative approach, which would be to let Zambian policy-makers take control and formulate their own policy and then only come in and support it if it is sufficiently sensible and incorrupt. The traditional *ex ante* conditionality has obviously in the case of Zambia been able to drag an unwilling regime onto the reform path, but in spite of this the economic outcomes have been poor. This is consistent with the results of a recent study by Easterly (2001), which shows that adjustment loans from the IFIs have not had any measurable impact on growth, while similar reforms undertaken by countries that have not had adjustment loans from the IFIs have often been successful. It is not inconceivable that it is the packaging of the reforms that make the difference. The IMF/World Bank forced reform packages relieve the government of responsibility and does not elicit commitment, and therefore implementation and results are poor.

It is likely that the ineffectiveness of policy implementation is partly to blame on the current aid relationship. Moreover, bilateral donors and the IFIs have been at odds several times and sent conflicting signals. Bilateral donors withheld balance of payments support after the exclusion of Kaunda from the 1996 elections, and once again when progress on the privatisation of the mines failed to materialise. With regard to the regular aid programmes, however, the bilaterals have continued to pay up, while a major concern of the IFIs was to see to it that Zambia continued to service its debts. Aid to Zambia, or even its temporary withdrawal, has been a poor basis for inducing a committed reform process. Thus, for the needed improvements in the country's governance structure to come about, there need to be changes in the nature of the donor-Zambia relationship with a view to enhancing ownership and mutual responsibility (Adam et al, 1994, Collier, 1997 and 1999). Recipient countries need to feel that they are in control not only of the policy content of their reform programmes, but also of the pace of implementation. Ensuring a high degree of ownership on the part of host governments is the best way to enhance programme sustainability.

Implications for domestic politics

Ultimately policy implementation depends on the nature of domestic institutions and politics (Dollar and Easterly, 1999). Dollar and Svensson (1998) find that the success of structural adjustment programmes has depended on domestic institutional and political factors and not on variables controlled by the World Bank, with democratic and newly elected governments tending to be more willing to implement reforms. While studies of the relationship between democracy and growth have been largely inconclusive, growth seems somewhat more likely to occur in countries where the population enjoys a degree of civil and economic liberty (Alesina and Perotti, 1994). In any case, political instability has a clearly negative effect on growth.

Still, the growth process will not become self-sustaining unless the recipient country has a reasonable measure of control over the policies being implemented. It is thus important that the reform process is not too heavily dependent on donors. The reform programme launched by the MMD soon stalled due to the unwillingness of groups both within and outside government to give up their privileges.

Another aspect highlighted by Zambia case is the difficulty of developing on a sustainable basis an active civil society. While many NGOs were engaged in the fight for democracy, feeling it to be their task to help in the dismantling of the one party state, once they had achieved their goal they became less effective. Few found it worth their while to continue to work towards the development of a democratic citizenship through political advocacy, monitoring of the government and education of citizens (Bratton et al, 1999). This absence of a 'watchdog', in a political environment dominated by the ruling MMD, probably partly explains persistent charges of laxity and corruption in government. In the last year, though, there has again been an increased intensity in the political debate as President Chiluba tried to build support for a change in the constitution making it possible for him to continue for a third period in office.

The labour movement was the most vocal opponent of the government in the last years of the Kaunda regime and thus became a natural ally of the new government. In retrospect, however, removing Kaunda from office after close to 30 years in power, seemed more important than scrutinising the future policies of the MMD. The power of the labour movement has been reduced in the past decade, thanks to a weak labour market and new legislation against strikes (White 1999).

Political conflicts have not been primarily about the content of policy but about the division of the spoils enabled by access to business opportunities in the form of tenders or privatised businesses or by getting access to assets or incomes from the remaining parastatal industries. Since the new political parties essentially consist of the same group of people as under the old system, the government cannot pursue a reform agenda without regard to the need for political support.

The Zambian experience shows that the major constraints on achieving sustained growth are to be found in the areas of institutional reforms and governance. Such reforms have more clear-cut costs for stakeholders than general macroeconomic reforms, and they will therefore meet with much more resistance. In spite of the move towards multiparty democracy, the political process has been much harder to change in Zambia than was envisaged in the early 1990s. The political sphere thus continues to be the main stumbling block to durable reform.

A major conclusion from our analysis is that the political economy of policy making is crucial. In a large cross-country project, Lal and Myint (1996) found that that the initial resource endowment was more important in determining policy outcomes than the polity. Labour-abundant countries, such as Korea and Taiwan, had an easy policy-making task and could follow the prescriptions based on the standard Heckscher-Ohlin model of concentrating on labour-intensive production and then move up the ladder of comparative advantages as capital was accumulated. A major reason why this development path is relatively smooth is that it leads to desirable factor price changes, that is, increasing real wages as more capital is accumulated. The bulk of the population will gain and thus not resist the policy. Also the various types of autonomous states will find it in their interest to pursue a development strategy that uses its abundant resource intensively.

The comparative advantages of the natural resource abundant countries are also relatively straightforward. Lal (2000) give several reasons why they may be more difficult to realise. First, with a higher supply price of labour than the labour-abundant countries, its comparative advantages are in more capital- or land-intensive types of production. Public intervention may be required to realise bulky investments, develop specific skills and to absorb advanced technology. This opens up the potential for bureaucratic failure, which then may undermine growth potential. The second point is that if capital accumulation is not fast enough, and with a rapidly growing labour force, the optimal development path may imply falling real wages. This may lead to political pressures for measures to avoid this by turning inward. Thirdly, to avoid the falling wages many countries have attempted to undertake big push development programmes, which have often been financed by foreign borrowing, leading to high indebtedness. Fourthly, given the rents available from the natural resources, there has been extensive politicisation of the distribution of these rents. This has severe effect on the rent-generating sector, particularly when terms of trade decline. It is not uncommon that the wealth of natural resources leads to a policy that destroys the sector that generated the rents. Generally Lal and Myint did not find any relationship between the form of government and economic performance. Instead they found that it was the availability or lack of natural resources that was the major determinant of policies that affected the efficiency and volume of investment and thus the rate of growth.

The Zambian experience as reviewed in this paper has all the elements just listed, and our analysis suggests that resource-rich countries are in a fix that is hard to get out of. The governance issues are particularly problematic in a setting where the main source of government revenue is a rent. This opens up the field for distorting interventions and corrupt practices that benefit a small group of insiders, while the large group of outsiders pay the price. The latter have incentives turned against them, at the same time as they do not see much of the benefits of the rents of the national resource.

It is hard to come up with simple policy recommendations, when the policy makers themselves are the key problem. For governance to improve in such a setting the incentives and constraints must be such that the government finds it in its own interest to pursue socially sensible policies. An open debate and functioning democratic and judicial control helps by increasing the costs of corrupt and inefficient behaviour, but so far these forces have been too weak in the case of Zambia. Alternatively, as the elite builds up its economic interests outside the government, the economy may eventually come to a point where the benefits of having an efficiently run economy outweighs those of having one with extensive scope for rent-seeking.

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