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On the relationship between resource funds, governance and institutions: Evidence from quantile regression analysis

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A R T I C L E I N F O

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A B S T R A C T

This paper uses quantile regression estimation techniques so as to investigate the relationship between resource funds, governance and institutional quality by paying special attention to the distribution of the latter. The estimation results indicate that resource funds are associated with better governance and institutions. The positive correlation is identified for the entire distribution of governance and institutional quality variables indicating that resource-rich countries can benefit from the establishment of resource funds, irrespective of whether they are found at the lower or at the upper end of the ranking of governance and institutional performance. The results offer evidence in support of the view that resource funds are valid tools of insulation against the "resource curse" as manifested through governance and institutional quality deterioration. Resource funds may support policy making and strengthen governance and institutional formations not only in countries with good governance and institutions but also in countries which lag behind in the latter.

Introduction

Natural resource wealth has been found in many studies to adversely affect economic growth and development (see Sachs and Warner, 1995 and Bruckner, 2010 among others). This phenomenon labeled as the "resource curse" has been related among other things to the adverse impact that natural resource abundance can have upon governance and institutions (indicative is the work of Bulte et al., 2005, Collier and Goderis, 2008 and Karl, 2008). Institutional economics have brought the importance of institutions to the forefront of the debate on economic growth and development. Following this trend, a growing amount of relatively recent literature has shifted the research focus on the role of governance and institutions as determinants of economic growth and development in resource-rich countries (see for instance Acemoglu et al., 2001). Resource riches have been associated with deteriorating institutions and governance as they induce rent-seeking, corruption and patronage. In recent studies worsening governance and institutions in the presence of natural resources are considered to be *the* growth and development problem of resource-rich countries (see for instance Kolstad and Soreide, 2009).

In the attempt to identify the remedies to the "resource curse", recent studies have been looking at the establishment of resource funds (see Davis et al., 2001; Shabsigh and Ilahi, 2007 and Tsani, 2013). The primary aim of resource funds is to assist the macroeconomic and inter-generational management of resource wealth insulating the economies from the abrupt fluctuations of commodity prices and save part of current wealth for future generations. Theoretical approaches in favor of resource funds support the view that they can insulate resource-rich countries from excessive commodity price volatility, can allow for the smooth injection of resource revenues into the domestic economy and ensure macroeconomic and fiscal stability along fair inter- and intra-generational allocation of national resource wealth (Tsalik, 2003; Bacon and Tordo, 2006). Opposing views to the usefulness of resource funds argument on their limited coordination with the budgetary process and their vulnerability to weak monitoring (Davis et al., 2001; Barnett and Ossowski, 2003). The theoretical discussion on the usefulness of resource funds as tools of economic policy has challenged their effectiveness arguing that resource funds can add little in the absence of strong institutions, while they can have limited, if any, impact when strong institutions are in place. Sugawara (2014) argues that if a resource-rich country maintains sound fiscal policies and appropriate management of natural resources, the country might not need to establish a resource fund to separate the revenue and expenditure cycles. On the relationship between resource funds, governance and

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institutions a recent study by Tsani (2013) has shown that resource funds may serve as a tool of insulating resource-rich economies against the adverse effects of resource wealth and support government effectiveness, rule of law and control of corruption in countries rich in natural resources. Empirical results showed that countries which have established resource funds perform better in terms of governance and institutional quality as compared to the countries that have not established resource funds.

These recent findings which identify a positive correlation between resource funds, governance and institutional quality, offer some first arguments in support of the establishment of resource funds in countries abundant with natural resources with the aim to insulate them against governance and institutional deterioration and, via this channel, to protect them from the negative effects that natural wealth can have upon economic development and growth. Nevertheless little is known on whether the relationship between resource funds, governance and institutional outcomes changes with the level of governance and institutional quality. From a methodological perspective, empirical evidence on the relationship between resource funds, governance and institutional quality has been based on OLS estimations and on the assumption that the findings describe equally well all cases, irrespective of the levels of governance and institutional quality recorded across countries. Nevertheless it might be reasonable to expect this relationship to be more complex than the one depicted from an average correlation. It might be valid to assume that the establishment of resource funds might not have the same impact on all countries. One might argue that countries which rank high in governance and institutional quality might see limited impact on their institutional formations from the establishment of resource funds. These countries might already have in place sound fiscal and macroeconomic policies which leave little room for misappropriation of resource wealth and induced governance deterioration. Thus the establishment and the operation of a resource fund in this case might not be correlated with significant changes in governance and institutional quality. These arguments extend into the sphere of governance and institutions earlier discussion in the existing literature which supports the view that resource funds can add little in the fiscal and macroeconomic policies in countries where sound fiscal management of natural resources is in place (see for instance Barnett and Ossowski, 2003 and Sugawara, 2014).

For countries ranking at the lower end of governance and institutional quality indicators, two alternative assumptions could hold. In the first case one could argue that resource funds which are established in countries that score low in terms of governance and institutional quality can have a significant positive impact on the latter, and significantly higher from that recorded in countries which have high governance and institutional quality. The establishment of resource funds usually entails the provision of rules and regulations supervising the management of excess revenues from natural resources. In countries where governance is weak and the economic policies followed are not robust, the establishment of a resource fund and the provision of rules on the management of natural resource wealth might offer an initial context of appropriate management of resource riches. In other words resource funds might impose in these countries the self-constraining rules which can guarantee, even to a limited degree, the prudent management of resource wealth fostering thus government effectiveness and the rule of law. In terms of transparency, the presence of a resource fund might allow the tracking of the payments related to natural resource wealth, the sources of revenues as well as the management of excess money. In this way the presence of the fund could impact on the government effectiveness in managing resource wealth and the control of corruption induced by the management of natural resource wealth.

The latter assumptions are associated with earlier findings in the literature which show that explicit tools of fiscal policy extend beyond being merely veils as they can have real effects on economic performance and political economy (see Poterba, 1996 and Alesina et al., 1999). In several countries which score rather low in governance and institutional quality indicators the establishment of resource funds has followed consultation with international financial institutions. In other countries the establishment of the funds has adopted methods employed by other successful examples when setting out the rules governing their operations and structure (the Norwegian oil fund in particular has been a popular example, the practices of which have been claimed to be followed by recently established funds like that of Kazakhstan for instance). Many of the resource funds operating in countries which score low in terms of governance and institutional quality have an international portfolio of investments. Given the concerns in the countries receiving investments from such funds as well as the international calls for greater transparency in the operations of the funds[1], international initiatives have been developed in an attempt to provide a common framework and a minimum of transparency provision of the funds (see for instance the Santiago Principles[2]). In an attempt to be welcomed in the international financial markets many resource funds have aligned their operations and rules with international standards and requirements. Thus it might be reasonable to expect that the establishment and the operation of resource funds in these cases have imported to the host countries “good” standards on the management of natural resource wealth which in their turn could have a real impact on the governance and institutional quality of the countries which could lead to a substantial change on the latter. Thus it might be argued that the presence of resource funds might be positively correlated with governance and institutional quality and this correlation can be significant even in countries scoring at the lower end of governance and institutional quality indicators.

An opposing argument could state that in countries which are found at the lower end of governance and institutional quality indicators, the establishment of a resource fund would not have any significant impact on the latter. Even if resource funds are associated with governance and institutional quality developments, the correlation in countries found at the lower end of governance and institutional ranking would differ from that identified for countries found at the higher end of it. In countries which score low in terms of governance and institutions the establishing rules of the resource funds and their coordination with the budgetary process would fail to provide for an efficient and transparent management of natural resources. In countries where governance and institutions are weak, the prospects of establishing a well-functioning fund may be limited. In order for funds to be supportive towards greater government effectiveness, rule of law and control of corruption, a minimum level of governance and institutional quality is necessary. This is required so as to set basic operational and management lines of the fund which can guarantee even to a limited degree its efficient operation.

The present paper is motivated by the discussion summarized above. The aim of the paper is to advance the debate on the relationship between resource funds, governance and institutions by introducing in the analysis the importance of the differentials recorded in the quality of the latter. The goal is twofold: (i) to provide evidence on the relationship between resource funds, governance and institutional quality and (ii) to investigate whether this relationship differs among countries with “good” governance and institutions, and countries which score relatively worse in their governance and institutional settings. In this way the paper aims at complementing the debate on whether resource funds can be associated with governance and institutional quality in resource-rich countries but also to

[1] See: European Commission (2008a, b), US Treasury (2008a, b) and Tsani et al. (2011).

[2] See: International Working Group on Sovereign Wealth Funds (2008).