Resources Policy 53 (2017) 226–237

Contents lists available at ScienceDirect

Resources Policy

journal homepage: www.elsevier.com/locate/resourpol

Turning resource curse into development dividends in Guinea-Bissau

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ARTICLE INFO

JEL Classification:
H59
L72
O43
O55
Q33

Keywords:
Resource Governance
Resource Curse
Public Financial Management
Africa

ABSTRACT

This paper explores the potential risks related to the resource curse for Guinea-Bissau. To date, the country is not yet a producer of extractive resources, but its potential is high and investments are materialising. Cognisant of this, the authorities set mining/extractive industries as a core tenet of the national strategic and operational plan laid out in 2015. Risks analysed in this paper relate on the one hand to potential resource curse effects (e.g., enclave and Dutch disease), and on the other to the challenge of public financial management (PFM) and transformation of revenue into investments. Using a governance and PFM prism as analysis framework, the paper finds gaps between the de jure and de facto governance framework related to extractives. Stemming from this, policy responses are looked at including key reforms in anticipation of extractive revenues such as strengthening of PFM systems and the budget process in particular, and investing in transparency through avenues combining bottom-up (e.g., local civil society) and top-down (e.g., international compacts) approaches. Steps aiming at welcoming international transparency regulation or developing realistic local content policies are also proposed.

1. Introduction

Extractive industries can potentially lead to poverty alleviation and sustainable development on the basis of positive effects stemming from, among other things, foreign direct investment (UNCTAD, 2007). Yet they can prove a double-edged sword, as they may fail to yield the expected results or even have negative effects. Evidence shows that countries with natural resource abundance are more likely to be worse off than other countries in the same geographic region or income range (Sachs and Warner, 1995; Collier and Hoffler, 1998, 2005). This is particularly the case in countries with fragile institutions and a rather weak economic fabric. Weaknesses in the former can bring about further fragility and political strife, while the latter could potentially lead to economic stagnation or destabilization.

Which states are prone to suffering from the so-called resource curse is difficult to predict as there is no simple single explanation of what creates such a curse (Stevens, 2003). Empirical assessments, however, suggest that clues may be found in a state's baseline levels of institutional development, economic structure, and political status. As non-democratic countries with weak institutions, poor judicial systems and low level of trade openness have historically proven to be the most vulnerable to the resource curse (Arezki and van der Ploeg, 2008; Polterovich et al., 2010), emphasis has been increasingly placed on governance and institutional capacity as key factors (World Bank, 2006; Mehlum et al., 2006).

The present paper uses the case of Guinea-Bissau to explore the potential risks related to the resource curse, and delves into the economic and financial governance preconditions to turning the resource curse into development dividends. To date, Guinea-Bissau has known potential in extractive resources, among them phosphate, bauxite, and heavy sand. The presence of hydrocarbons is not yet confirmed but there are indications that commercial exploitation can occur in the medium to long term. Yet considering the country's political track record of over 15 coup attempts since independence in 1974 (four of them successful), as well as its lack of economic diversification, weak governance and high poverty rates, natural resource exploitation could expose the country to disappointing development outcomes, or to high risks in the worst case scenario.

This type of analysis is seldom undertaken ex ante, in particular with countries prone to fragility. Complications are often assumed to be dealt with through mainstream governance reforms once extractives are yielding benefits. Yet literature has increasingly put forward the importance of contextualising and tailoring policy interventions to avoid the promotion of unfit isomorphic reforms (Andrews, 2008) that condition end results. This paper takes a 'bespoke' reform treatment as a core tenet of effective resource policy, focusing on economic govern-

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http://dx.doi.org/10.1016/j.resourpol.2017.06.018
Received 17 March 2017; Received in revised form 29 June 2017; Accepted 29 June 2017
0301-4207/

ance in Guinea-Bissau, a country that has received very little attention in the governance literature as a whole.

As far as institutional governance is concerned, there are essentially two types of risks related to the expansion of extractive industries and their corresponding cash inflows for Guinea-Bissau: the introduction of further *adverse incentives within institutions* (increased corruption, insiders' retention, etc.) and a *corresponding increase in institutional inefficiencies* leading to bad policy decisions. On the economic governance front, the task is also twofold: avoiding *potential resource curse* effects on the one hand, and securing sound *public financial management (PFM) and the transformation of revenue into investments* on the other hand. Although the term *governance* can have a broad meaning, the paper narrows it to economic governance and public financial management.[1] This paper focuses on the economic angle using a qualitative and inductive approach through a governance and PFM prism.

Section 2 of the paper reviews the literature focusing on the relationships between extractive industries, governance, macroeconomic management and the resource curse. Section 3 introduces the Bissau-Guinean context. Section 4 presents the methodology and Section 5 lays out the analytical framework. Section 6 looks at the first angle of the economic governance challenge, namely public financial management. Section 7 delves into the second aspect, focusing on policy avenues to address the resource curse by forestalling the Dutch disease mechanism of transmission. Section 8 concludes.

2. Literature review

The resource curse literature can by and large be subdivided into three main areas. The first area studies the relationship between resources and economic performance. Studies over the past 20 years have found that resource abundance is negatively correlated with economic growth (Sachs and Warner, 1995; Leite and Weidmann, 1999; Neumayer, 2004), and can lock countries into dependency (Taylor, 2016). The second area looks at the relationship between resources and conflicts, finding that resource abundance is a strong determinant for the start of civil wars, can worsen their intensity, and is negatively correlated with successful peacebuilding (Collier and Hoeffler, 1998, 2005; Ross, 2004; Doyle and Sambanis, 2000). In the third area, the literature delves into the relationship between resources and democratic governance, with a debate on the nature of the correlation between natural resource wealth and low levels of democracy or weak institutions (Wantchekon, 1999).

Excessive reliance on natural resource revenues also presents the risk of a country becoming a rentier state,[2] which tends to be linked to decreases in transparency and governance accountability. A consequence of this situation is a decrease in policy efficiency as governments tend to gear their actions toward economic interventionism (or become predatory?) rather than toward regulation or supervision, spurring wastage and inefficiencies (IMF, 2009). Another consequence can be imprudent fiscal policy. For instance, governments may fall into the trap of engaging in excessive borrowing against expected revenue based on potentially volatile commodity prices. They may have difficulty cutting budgets during a price bust, and tend to over-borrow when prices are high.[3] A key issue here is the strength and adequacy of PFM systems, which are needed for transparency, accountability and policy setting.

One traditionally highlighted transmission mechanism of the resource curse is the so-called Dutch disease phenomenon. This premise of the concept is that instead of boosting the country's wealth accumulation, the exploitation of a new resource translates into a loss of competitiveness within the national industry, sparking a deindustrialization process in the following decade. The unexpected and rapid increase of revenues causes the appreciation of the local currency, which makes the agriculture and industrial sectors less competitive, and eventually adversely affects export-led growth (Bategeka and Matovu, 2011).

Building on Corden and Neary's (1982) basic model of Dutch disease, the literature has shown that the deindustrialization process it entails (beyond the currency appreciation factor) is the result of a twofold effect (Neary and van Wijnbergen, 1986; Gylfason, 2001; Brahmbhatt et al., 2010). On the one hand, the resource movement effect, through which the booming sector attracts capital and labour away from the other sectors, can directly cause deindustrialization. On the other hand, the spending effect, through which the revenue boom entails an increase of public and private expenses, can create excess demand for non-tradable goods (services and construction) and drive up non-trade sector wages and prices. Thus, the new sector attracts capital and labour away from tradable sectors (agriculture and manufacturing), causing deindustrialization indirectly.

Numerous aggravating factors explain the intensity of Dutch disease, depending on the nature of the booming sector and the institutional context in which this takes place. For instance, the more the booming sector is an enclave, with few linkages producing only small spillover effects on other sectors of the economy, the more likely the boom is to affect the latter's competitiveness. Likewise, the less developed and diversified the country's economy, the more the spending effect will ripple through the entire economy due to the weak capital absorptive capacity of other existing or nascent sectors (Berger, 1982). Also, the more the booming sector is a rent sector, the likelier it is to lure entrepreneurs and rent-seekers, therefore depriving the country of the skills and investment capacities required in any economic diversification process (Sachs and Warner, 2001). In weak institutional environments, this situation creates new space for corruption opportunities, which could in turn exacerbate the benefits deprivation effect as gains are captured by local elites.

The relevance of the Dutch disease phenomenon has been questioned, however, based on the finding that in many resource-rich countries, such as Malaysia or Norway, for instance, the tradable primary resource sector drove economic growth and development externalities (Mahani, 2001; Larsen, 2006). This led researchers to identify other explanations for the resource curse, including political-economic, cognitive, societal and institutional factors, which either strengthen or counter the Dutch disease mechanism. In particular, two central explanations have been suggested (Maloney, 2008). The first is a deficient national innovative or learning capacity, which prevents adding value, increasing productivity and upgrading activities in the resource sector. The second lies in the anticompetitive barriers to technological adoption and new entry in the sector, in favour and at the instigation of insiders. By contrast, some countries that successfully induced resource-driven growth have done so by ensuring learning-by-doing externalities in the primary tradable sector, through technological progress and investments in appropriate knowledge (Wright and Czelusta, 2002). In both cases, bad and good practices have to do with absorptive capacity and behavioural factors – two challenging aspects in Guinea-Bissau.

Combined with the complexity of the mechanism's operation, these

[1] *Governance* can be defined as "a set of processes, policies, laws, behaviours, and institutions that affect the manner in which power is exercised in the management of a country's economic, financial and social resources" (AfDB, 2014).

[2] The definition of *rentier state* is somewhat arbitrary. In this paper, it refers to states where the sources of the rent overshadow the rest of the economy (Yates, 1996). For Guinea-Bissau, as shown in this paper, a natural resource boom will effectively lead to dual sources of rent – extractives and cashew nuts – while other sectors would be secondary.

[3] There are numerous examples in this regard such as Mexico's spiralling growth in spending on the back of a small three-year windfall in oil revenues in the late 1970s, or Angola's recurrent budget and debt crises due to borrowing against expected oil revenues (IMF, 2009).

(*footnote continued*)