



Working Paper in

THE ROLE OF FOREIGN DIRECT INVESTMENT IN RESOURCE-RICH REGIONS

Resource Curse Dynamics, the Corporate License to Operate, and the
Potential of Direct Cash Dividends

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Introduction

The discovery of concentrated natural wealth—such as oil, gas, diamonds, or gold—should be a tremendous benefit for a country. But far too often it is instead associated with poverty, economic stress, and poor governance. Similarly, the discovery of concentrated natural wealth can be a tremendous opportunity for foreign firms with the technical expertise, experience, and capital to exploit those resources. But far too often, companies become embroiled in local politics, accused of not contributing enough to the country, and criticized for not creating enough economic opportunities for the broader population.

Many companies have tried to overcome this problem through strategies of denial or deflection. Some firms contend that they are a private firm without public responsibilities; they pay royalties and taxes, they employ local nationals, they serve their shareholders in a manner that is proper for a foreign firm. This strategy often does not work, especially in low-income countries. Instead, foreign firms are exposed to high and usually shifting expectations, powerless to influence the use of funds paid to the host government, and limited in capacity to do much more to directly and visibly benefit the population. The incentives for the firm are to minimize exposure to local demand and, even if the firm wanted to encourage better outcomes, the government stands between the firm and the population.

Other firms, including those who have found the denial and deflection strategy insufficient, have attempted a modest approach to tackle the symptoms of underdevelopment. This may include funding high-profile projects, making contributions to charitable funds unrelated to the core business, or other efforts to show the government and the population the positive contributions of the company to national goals. These efforts are sometimes more successful, but have three obvious shortcomings. First, the company's development efforts can wind up raising expectations and encouraging an ever-rising list of special requests. Second, such efforts pull the company further from its core business and into activities that are beyond the mandate and core skills of the firms. Finally, such efforts can have the opposite effect of that intended by entangling the company even further in local political matters.

This paper presents a third option that may, under certain circumstances, solve this problem for citizens, governments, and companies: direct cash dividends.

Section two summarizes the dynamics of the resource curse, with special attention to the welfare and governance effects. Section three explains the concept of direct dividends and section four covers some of the potential benefits of cash. The final section concludes with why this approach might be especially useful to international firms in the extractive industries.

The Resource Curse

It is now widely understood that many resource-rich countries remain poor, conflict-ridden, and corrupt. The so called “resource curse” has a long body of research going back to the 1980s that have sought to establish (or to debunk) theoretical and empirical links between natural resources and a host of negative outcomes. A summary of what is generally understood as the economic and political effects are presented here:

Bad for economic growth?

A seminal study found that economic dependence on oil and minerals correlated with slower economic growth across 100 countries going back centuries.¹ They noted gold-rich 17th Century Spain trailed resource-poor Netherlands and a more recent phenomenon of East Asian Tigers far surpassing oil-rich Venezuela and Nigeria. More recent studies have varied in their findings depending upon country samples and how resources are measured.² A reasonable conclusion, based on fifty years of data, suggests no universal rule³, but rather raises important questions: why do countries with a wealth of natural capital not grow faster than those without? And what are the determinants of successful growth from resources (e.g., Botswana, Norway, Chile) versus those that fail to capitalize on this opportunity (Nigeria, Congo, Venezuela)?

Bad for income inequality?

Even if resource-abundant countries grow fast, the benefits of that growth may not be well distributed across the population. In some cases, control over concentrated resources by a small elite can worsen inequality, with both economic and political consequences. One important study found the larger the share of commodity exports, the more unequally income is likely to be distributed among the population.⁴ It is also true that many rich oil-producing countries have deeply poor populations. In an extreme example, Equatorial Guinea is among the very richest countries in Africa (GNI per capita is about US\$8,000), yet three-quarters of the population lives below the poverty line.

Bad for democracy?

Oil producers account for a high proportion of autocratic states, while durable transitions to democracy are rare. One study found that democratic transitions are about 50 percent more likely among non-oil states than among oil states, while another reported that attempted shifts to democracy in poor countries have failed twice as frequently in oil producers.⁵ Although the issue remains far from settled⁶ concentrated revenues clearly affect the political dynamics of producing countries and oil revenues particularly seem to insulate governments from public pressure.

Bad for governance and corruption?

Petroleum and minerals appear to be associated with higher rates of corruption.⁷ Unstable governments and weak institutions struggle to detect and punish graft,

making it more likely that oil and mineral revenues will end up in overseas bank accounts rather than in local schools and hospitals.

Bad for peace?

Countries rich in oil and minerals also appear to be particularly susceptible to civil conflict.⁸ Diamonds and oil have in the past financed brutal conflicts in Sierra Leone and Angola, while the Democratic Republic of Congo, for all its tremendous mineral wealth, appears permanently mired in strife. Since the early 1990s, oil-producing countries have been about 50 percent more likely than nonproducers to experience civil war.⁹ Yet, there are unsettled debates over the universality of this pattern and what might be the main explanatory channels.¹⁰

While researchers debate the existence and possible explanations for the resource curse, two reasonably certain conclusions can be drawn: First, there is something different about oil and mineral revenues that produces or contributes to negative economic and political outcomes in some countries. Second, this is neither a universal pattern nor a pre-determined path. Many resource-rich countries are relatively well governed and prosperous, such as Canada, Australia, and Norway. Chile and Botswana are among the most successful economies in Latin America and Africa, respectively, and both are highly specialized mining economies. One strand that binds these countries together is the existence of relatively developed human and institutional capital long before revenues from natural resources began to arrive. Such examples thus may provide insight into the mechanisms of the resource curse, but perhaps not a practical solution for countries starting out with poor governance that then discover natural resources.

Instead of trying to emulate Norway, mitigating or countering the risks of the resource curse must start with a deeper understanding of the dynamics and mechanisms. What is it about natural resources that seems to lead to negative outcomes, especially for poor countries with weak states? Extractive resources, particularly oil and minerals, with their high economic rents, are different from other industries in multiple respects:

- Exposure to high volatility in global prices;
- High concentration in physical space and economic activity;
- Low labor requirement with relatively low degree of spillover to the rest of the economy;
- Provide substantial revenue directly to government rather than indirectly through taxes levied on private sector activity.

All of these factors contribute to the economic, political, and institutional channels through which the resource curse raises the risks of negative outcomes.

Extractive commodity prices are extremely volatile and they typically account for a substantial percentage of exports and government revenues. Unless well managed, price volatility translates into wild fiscal swings for economies that rely heavily on commodity exports. Worse, price volatility is often compounded, rather than counterbalanced, by pro-cyclical fiscal policy; governments find it easy to boost

expenditure when oil prices are high but much harder to rein in spending when prices fall. The boom-bust cycle is detrimental for the nonoil economy, creating a vicious cycle that makes countries even more reliant on the extractive revenue. This can further drive inequality as macroeconomic instability harms people unevenly; the poor are least able to hedge risks.

Another mechanism commonly blamed for the damaging impact of oil and minerals on economic welfare is so-called Dutch disease. The term was coined in the 1970s in reference to the erosion of the Netherlands' manufacturing sector in the wake of rising costs driven by the inflow of gas resources.¹¹ More generally, Dutch disease refers to the risk that a sudden influx of hard currency – e.g., from the sudden production of natural resource exports – appreciates the real exchange rate, driving down the competitiveness of other non-resource sectors, harming or displacing other industries, and leaving the country even more dependent on resource income than before production. This phenomenon may be one reason why diversification has proven particularly difficult for oil producers and others with dominant enclave sectors.

Remedies to encourage economic diversification include adopting active monetary policy, improving the business climate, and removing barriers to foreign investment. In places like Indonesia, Malaysia, and Chile prudent spending to secure macroeconomic stability, a largely open trade policy, and investment of oil and mineral revenues in other export sectors have been credited for such success.¹² But in many other countries, resource revenues have driven out the nonoil sector; the rapid decline of manufacturing in Nigeria provides one stark example.

In addition to the economic effects, resource income can have an important influence on governance, especially through the tax and accountability channels. The problem is fairly simple arithmetic: the more income oil or minerals generate for a government, the less that government needs to rely on taxes from the wider economy and the broader population. One study found, for instance that, on average, a one percentage point increase in oil revenue in relation to GDP is associated with a 0.2 percent reduction in nonoil revenues.¹³

The effect of this goes far beyond fiscal revenues: the collection of taxes is essential to creating incentives for governments to be accountable and responsive to their populations. Taxation is at the root of the social contract, the implicit bargain between the state and its citizens.¹⁴ In many resource-rich countries, however, citizens lack bargaining power precisely because they do not pay taxes. Even if citizens can monitor government spending, they have little leverage to push for change in a government that receives its income from another source. At the same time, governments that do not depend on citizens for funding do not need to pay attention to citizen demands. At its base, resource revenue breaks the bonds of the social contract.

Conversely, governments that rely on broad taxation for revenue have a greater incentive to promote their national economies. When governments are funded by oil or mining revenues, they can afford to be indifferent to the fate of nonoil sectors, but if

their revenues are tied to the performance of the broader economy, fostering economic development becomes a matter of self-interest. Without the accountability of the social contract – and the stronger bureaucracy and institutions that go with it – oil and mineral producers tend to squander windfall revenues. Free from citizen scrutiny, oil money unsurprisingly tends to disappear – bad investments, inefficient subsidies, inflated civil services, and corruption.

There are few effective prescriptions to avoid the curse. Counseling countries to spend wisely, build strong solutions, or avoid corruption are more apt as descriptors than practical advice – the policy equivalent of recommending insomniacs to get more sleep. Two important steps have, however, reached a general consensus: utilize sovereign wealth funds and promote transparency.

Ringfence revenues and create sovereign wealth funds with fiscal rules

To help manage windfalls, many countries have created special fiscal institutions to ringfence extractive revenues into special funds. Some such stabilization funds are meant to smooth out boom-and-bust cycles by saving during times of plenty, when commodity prices rise above a set value, and by spending when the pendulum swings back. Other countries set up longer-term sovereign wealth funds, either to save national wealth for future generations or to hold money overseas to inoculate their economies against the macroeconomic effects of Dutch disease.

Yet for all their popularity, such funds are no guarantee that resource revenues will be better managed, and their performance has been mixed. Funds are easy to create but hard to maintain. Price volatility, weak institutions, and political pressure to spend and capture oil wealth – all the same maladies of the resource curse itself – all conspire against such funds too. The experience of the Chad-Cameroon pipeline is illustrative: in 2003, Chad set up an internationally managed fund at a bank in London with strict allocation rules as part of the conditions of a World Bank loan to build a pipeline to transport oil for export. Despite the model being based on best practice and drawing international scrutiny, Chad's government began to violate the World Bank's provisions almost immediately after oil started flowing. Eventually, the arrangement was abandoned. Neither international actors nor Chadian civil society could prevent the break down. The lesson drawn is that without a powerful constituency to advocate for prudent fiscal management, stabilization funds and fiscal rules are empty shells that do little to ensure the proper management of natural resources. A sovereign wealth fund structure alone, no matter how sound on paper, will do little to ensure good resource-revenue management. The structure may exist; the incentives do not.

Transparency of inflows

Another step forward has been enhanced transparency for an historically opaque sector. The Extractive Industries Transparency Initiative (EITI), for example, is a coalition of governments, companies, international organizations, and civil society, to encourage oil and mining companies to publish how much they pay, and governments to report what they receive. This and related civil society campaigns for even greater disclosure signal

a growing realization that hidden income streams present risks for all sides. While EITI and the publish-what-you-pay movement have been successful at increasing the *supply* of information about the revenue flow from the sector, neither address the *demand* for transparency on how contracts are agreed, how budgets are set, or where the money goes once it lands in public coffers. Without a constituency willing to use this information to scrutinize the government, and the power to bargain and hold the government to account, the information sits in reports, and the outcomes remain largely unchanged.

The Option of Direct Cash Dividends

One way to circumvent some of the resource curse dynamics, and begin to build the tax-for-services social contract, is to pay direct cash dividends. This is sometimes called national cash transfers, citizen dividends, or oil-to-cash.¹⁵ Rather than have the government receive all revenue and then allocate expenditure through the budget, a portion of the resource income would instead be paid directly to individuals. This approach is theoretically applicable to any windfall income, such as oil (e.g., in Ghana or Guyana), gas (Timor-Leste, Mozambique), gold (Mali, Ghana), copper (Zambia, Mongolia), ore (Guinea, Liberia, Goa), or even strategic locations that yield rental income (Djibouti, Panama). Regardless of the income source, any successful direct cash dividend program would require three basic facets: a dedicated fund to receive the revenues, clear rules for distributing dividends, and a tax system to claw some revenue back.

1. *Revenue fund*: Governments receiving revenues would first funnel most or all of these revenues, including signing bonuses, royalties, and other taxes, into a transparent and ring-fenced special fund. This fund – which could be an account at the central bank, a separate sovereign wealth fund or an offshore third-party fund – can serve multiple functions: to stabilize revenues, to promote transparency, and to serve as a mechanism for spending allocation decisions. By holding funds over multiple years and adhering to fiscal rules, the fund can smooth the volatility of income. A fund that publicly reports all inflows and outflows also provides a point of focus for external and internal scrutiny. Lastly, a separate fund helps provide the clarity needed for informed and responsible downstream spending decisions, including a division of allocation to short-term expenditure versus long-term investment and savings.

2. *Rules for dividends*: Once revenues accrue to the fund, part of them can be paid out to citizens on a regular schedule in an equal, universal dividend. The level of the dividend would also be set by clear and easy to understand rules, such as a percentage of the inflow or share of the profits. Calculating dividends based on clear and transparent rules removes political discretion and thus reduces the risk that politicians treat the dividend as a gift to constituents or that they can raid the pot. Instead, the concept is that citizens are *entitled to the dividend* – a legal distinction aided by the fact that (outside

of the United States) subsoil natural resources in most countries are owned equally by the population. Ideally, dividend amounts should be linked directly to revenues.

3. *Using the dividend mechanism to build tax capabilities:* The act of identification and linking every citizen to a financial account is useful for paying dividends, and also for establishing the plumbing for a board tax system. In fact, part of the dividend could be withheld or directly taxed back for public services. While this may seem inefficient, the act of paying and taxing helps to foster a culture of taxpaying which is typically absent in many low-income countries. More importantly, dividend plus taxation can help to create the social contract bond between people and the state. It forces governments to build a functional tax system and creates strong incentives for taxpayers to hold their governments accountable. The prospect of a regular dividend also creates strong incentives for citizens to register and participate.

Taxing oil dividends may appear like a heavy lift in countries where few people pay taxes and many may not have formal identification. Fortunately, technology allows all of this to be done easily and at low cost. Biometric ID and mobile money make this not only technically possible, but affordable. Further, a wholly electronic dividend system backed by biometric technology allows auditing and other steps to reduce fraud and waste.

The Alaska Permanent Fund

The US state of Alaska provides a useful example for parts of this proposal. After squandering its initial oil bonanza, the state established a sovereign wealth fund in 1976, backed by popular vote. The objective was to preserve part of the state's oil wealth for future generations. The Alaska Permanent Fund – now worth \$66 billion – receives 25 percent of state oil revenues to invest in income-producing assets. Since 1982, the fund's dividend program has paid every Alaskan resident an annual cash payment linked to the profits of the fund. This is typically around \$1,000 per person; the 2019 dividend is \$1,600. The amount is calculated by taking half of the average net income earned on the fund's capital over the past five years and dividing it by the number of state residents. While the dividend itself is a cash bonus for each resident, its real impact has been to help protect the fund itself by creating a vocal constituency with a strong interest in its survival and success. The popularity of the annual dividend has so far prevented the Permanent Fund from being raided by special interests, although ongoing fights have erupted over the dividend level in recent years. Some argue that the fund itself, despite the annual cash call on its earnings, would not be as large as it is today without the dividend, or even that it would not have survived without the dividend.¹⁶

Where Alaska has not followed this direct cash dividend model is the third step on taxation. Ironically, the state legislature abolished the state income tax in 1980 as part of the bargain that created the fund. Then governor Jay Hammond, who presided over the creation of the Permanent Fund and failed to veto the income tax removal, later reflected that “by repealing the income tax, . . . we reduced our means and severed the

major constraint on runaway spending: the cord that attaches the public's purse to the fingers of politicians."¹⁷

Components of a direct cash dividend already exist in many parts of the world. Bolivia has a program that is relatively close to this model. That country allocates about one quarter of the national direct tax on hydrocarbons to bankroll a program called Renta Dignidad, which provides regular income to retirees.¹⁸ Brazil and Mexico have large-scale national cash transfer programs targeted to the poor, and dozens of other countries have rolled out similar initiatives handing cash directly to citizens for a variety of purposes.¹⁹

The biometric ID and mobile money components also have multiple real-world examples that show it is feasible. India has registered more than one billion people with its biometric ID system. The cost of biometric enrollment in developing countries now averages about \$5 per registrant, and in India it is only about \$3.²⁰ Mobile money, where funds are stored electronically and transferred via simple mobile phones, is now very widespread, most famously through Kenya's M-Pesa. These technologies can be combined to implement a direct cash dividend, even in countries where the public sector has little capacity. Such services can even be contracted to private firms.

If implemented, a direct cash dividend would provide substantial economic benefits, including bolstering macroeconomic stability, creating visible and direct improvements in the welfare of citizens, and likely substantial efficiency gains relative to other ways resource income could be spent – or misspent. In many countries, extreme poverty could be eradicated overnight through a direct cash dividend. Evidence from cash transfer programs in Latin America and Africa suggest that most of the cash is spent wisely, that it boosts consumer demand, and that it generates positive multiplier effects throughout the local economy.²¹ The dividend can also provide funds for entrepreneurial efforts by a recipient who cannot tap the banking system for funds and thus can provide income growth in the country from the bottom up.

More than the direct economic and efficiency gains, a dividend would also align with better governance by encouraging positive incentives both for the public to hold their government accountable and for the government to respond to public demands. Redistributing rents to citizens and forcing the government to rely on taxes is akin to performance pay, tying government revenue to the broader growth of the economy.

Evidence of the Benefits of Cash

The evidence in support of cash transfers as a policy intervention is ample and growing. Countries across Africa, Latin America, and Asia have been experimenting with different models of providing cash to recipients in different amounts, timeframes, and for a variety of purposes. Part of the experimentation is driven by popularity and the relative ease of testing the effects of cash transfers in different environments, with economists using randomized control trials similar to pharmaceutical testing.²² Although the design, scale, targets, and objectives of cash transfer programs vary

widely, the general consensus from hundreds of studies suggests, when properly conceived and executed, giving money directly to people is one of the most effective ways to help the poor. A summary of the evidence suggests:

1. *Cash reduces chronic poverty and narrows inequality.* Living in poverty is trying to survive on a small and unpredictable income. This often means deprivation, lack of long-term investment in education and health, and making decisions with short-term benefits but long-term costs, such pulling children from school to work. Families in poverty also have fewer resources to cope with disasters or emergencies. That is why a steady income, even a small one, can afford the breathing space to ease, or sometimes to escape, poverty. The impact of cash transfer programs on poverty is well documented, especially in places like South Africa and Mexico which have long experience with regular cash benefits.²³ In addition to mitigating poverty, cash can reduce economic inequality. Evidence from Mexico's *Prospera* program, Brazil's *Bolsa Família*, and South Africa's cash grants all point to meaningful reductions in the gaps between rich and poor.²⁴

2. *Cash enables consumption and risk-taking.* Poverty usually means few resources for investing in the future or for taking chances on potential economic opportunities. There is growing evidence that cash payments can help to jump-start a virtuous economic cycle. First, transfers can help sustain local markets in poor and remote areas directly by boosting consumption as recipients are able to buy more food, household goods, seeds, fertilizer, or livestock. Cash programs across multiple countries in southern Africa been shown to stimulate local businesses and small entrepreneurs.²⁵ A regular income assisting with basic needs also provides a safety net that allows poor families to take more risks. Families can invest in farming technology or new businesses instead of stashing money away to use in emergencies. Programs in Ethiopia, Zambia, Paraguay, and Mexico, for instance, showed that recipients invested part of their cash transfers in farming, livestock, and microbusinesses.²⁶

3. *Cash can strengthen the social contract.* Establishing a direct financial channel between state revenues and its citizens can strengthen a country's social fabric and help build national identity. Through the social contract, the state and its citizens are bound by mutual obligations: authorities are expected to provide law and order, infrastructure, and public services, in exchange for which citizens owe allegiance to the state and are expected to respect institutions and pay taxes. A breakdown of this give-and-take threatens political and social stability. In some cases, cash transfer programs were introduced deliberately to promote national cohesion. Mexico's cash program was launched in part to address the roots of the Chiapas uprising, while Kenya extended cash programs after political violence rocked the country in 2008.²⁷ Similarly, Sierra Leone's and Nepal's cash distributions were designed to bolster social cohesion and contribute to peace processes.²⁸

4. *Cash can provide political benefits.* While the evidence is weaker about the influence of cash transfers on politics, there are very likely benefits that accrue to the politicians and

parties that introduce and deliver cash dividends. Studies from Mexico, Uruguay, and Brazil all suggest that voter behavior is affected, with politicians associated with cash gaining share.²⁹

Conclusion: Why would a large international company care about cash dividends?

Why does this any of this matter for a foreign company? Direct cash dividends are one way that companies can help to build and sustain a license to operate by ensuring that their investments in oil, gas, or mining produce visible benefits for citizens and help to make the politicians more popular. Direct cash dividends democratize the revenues and give everyone a stake in positive outcomes. They create incentives for the demand for transparency and sound management. For a company, direct dividends should also mitigate the need to become entangled in public services or to engage in other activities such as charitable giving outside of the core business. Most of all, a transparent and universal direct cash dividend, especially when paired with a broad tax system, can create positive incentives for both citizens to pay attention and for host governments to be more responsive. In short, direct cash dividends can help to build and reinforce the social contract that is at the heart of good governance and a stable long-term enabling environment for investment.

The contrast is business-as-usual. Royalties and bonuses often go to the central government with little flowing back to the local communities where the oil projects operate. The local communities frequently feel they are receiving little benefit from the wealth being extracted in their own backyard and then turn to the oil companies to fund local infrastructure, education, and health outside of the royalty and tax provisions of an oil concession. A cash-dividend would bring home to citizens that they are directly benefitting from oil companies operating in their area.

This is not to say that companies should attempt to implement dividends on their own, nor be seen trying to force unwilling governments to try this option. Instead, low key encouragement, including clarifying the potential benefits to all of such a system, and perhaps limited technical and financial support for establishment of a dividend program, makes more sense.

A final obvious question is, if direct cash dividends are such a great idea, why are countries not already doing it? Pieces of direct cash dividends are happening in every region of the world and the evidence of their success are increasingly clear. The political economy challenge is to find governments that also see direct cash dividends in their own interest. This is unlikely in a country with a long-entrenched regime where distribution of oil or mining rents is the principal source of patronage or the means for maintaining power. Indeed, in such markets, direct cash dividends may be seen as a threat to privileged elites and the political system. However, there may be opportunities for direct cash dividends among governments in transition to a new generation, leaders approaching retirement who are hoping to secure a long-term legacy, or especially in

places where the resource has been discovered but the revenues are still far in the future.

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